CLASSIFICATION ISSUES RELATING TO INDEPENDENT CONTRACTORS

HEARING

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

JUNE 11, 1982

Serial 97-72

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
96-488 O WASHINGTON : 1982

H781-49

COMMITTEE ON WAYS AND MEANS

DAN ROSTENKOWSKI, Illinois, *Chairman*

SAM M. GIBBONS, Florida
J. J. PICKLE, Texas
CHARLES B. RANGEL, New York
FORTNEY H. (PETE) STARK, California
JAMES R. JONES, Oklahoma
ANDY JACOBS, Jr., Indiana
HAROLD FORD, Tennessee
KEN HOLLAND, South Carolina
WILLIAM M. BRODHEAD, Michigan
ED JENKINS, Georgia
RICHARD A. GEPHARDT, Missouri
THOMAS J. DOWNEY, New York
CECIL (CEC) HEFTEL, Hawaii
WYCHE FOWLER, Jr., Georgia
FRANK J. GUARINI, New Jersey
JAMES M. SHANNON, Massachusetts
MARTY RUSSO, Illinois
DON J. PEASE, Ohio
KENT HANCE, Texas
ROBERT T. MATSUI, California
DON BAILEY, Pennsylvania
BERYL ANTHONY, Jr., Arkansas

BARBER B. CONABLE, Jr., New York
JOHN J. DUNCAN, Tennessee
BILL ARCHER, Texas
GUY VANDER JAGT, Michigan
PHILIP M. CRANE, Illinois
BILL FRENZEL, Minnesota
JAMES G. MARTIN, North Carolina
L. A. (SKIP) BAFALIS, Florida
RICHARD T. SCHULZE, Pennsylvania
BILL GRADISON, Ohio
JOHN H. ROUSSELOT, California
W. HENSON MOORE, Louisiana

John J. Salmon, *Chief Counsel*
Joseph K. Dowley, *Assistant Chief Counsel*
Robert J. Leonard, *Chief Tax Counsel*
A. L. Singleton, *Minority Chief of Staff*

Subcommittee on Select Revenue Measures

FORTNEY H. (PETE) STARK, California, *Chairman*

KEN HOLLAND, South Carolina
WYCHE FOWLER, Jr., Georgia
MARTY RUSSO, Illinois
ROBERT T. MATSUI, California
CECIL (CEC) HEFTEL, Hawaii
FRANK J. GUARINI, New Jersey

JOHN J. DUNCAN, Tennessee
RICHARD T. SCHULZE, Pennsylvania
GUY VANDER JAGT, Michigan
W. HENSON MOORE, Louisiana

CONTENTS

Page
Press releases anouncing the hearing ... 2

WITNESSES

Department of the Treasury, Hon. John E. Chapoton, Assistant Secretary for Tax Policy, and Hon. Roscoe L. Egger, Jr., Commissioner of Internal Revenue ... 4
American Bar Association, Section of Taxation, John S. Nolan ... 29
American Farm Bureau Federation, Grace Ellen Rice ... 143
American Federation of Labor and Congress of Industrial Organizations, Stephen Koplan ... 20
American Medical Association, Jerald R. Schenken, M.D. ... 66
American Movers Conference, G. Zan Golden ... 194
American Pulpwood Association, Kenneth S. Rolston, Jr ... 145
American Trucking Associations, Inc., Duncan McRae, Jr ... 183
Amway Corp., Richard DeVos and John Gartland ... 94
Barber, Monty, Direct Selling Association and Mary Kay Cosmetics ... 105
Beyer, John, Direct Selling Association ... 105
Brooks, Sam F., Brooks & Co., and Manufacturers' Agents National Association ... 132
DeVos, Richard, Amway Corp ... 94
Direct Selling Association, Monty Barber, Neil Offen, John Beyer, and Arthur J. Rothkopf ... 105
Electronic Representatives Association, Raymond J. Hall ... 83
Gartland, John, Amway Corp ... 94
Golden, G. Zan, North American Van Lines, Inc., and American Movers Conference ... 194
Hall, Raymond J., Electronic Representatives Association and Small Business Legislative Council ... 83
Koplan, Stephen, American Federation of Labor and Congress of Industrial Organizations ... 20
Lehr, Gustav J., Shelter Insurance Co., and National Association of Independent Insurers ... 122
Libin, Jerome B., National Association of Life Cos ... 117
MacArthur, Malcolm D., Specialty Advertising Association International ... 175
Manufacturers' Agents National Association, Sam F. Brooks and Steven Young ... 132
Mary Kay Cosmetics, Monty Barber ... 105
McHugh, Thomas J., National Association of Manufacturers ... 135
McNeer, John D., Newton Manufacturing Co., and Specialty Advertising Association International ... 175
McRae, Duncan, Jr., Melton Truck Lines, Inc., and American Trucking Associations, Inc ... 183
Melton Truck Lines, Inc., Duncan McRae, Jr ... 183
National Association of Independent Insurers, Gustav J. Lehr ... 122
National Association of Life Cos., Jerome B. Libin ... 117
National Association of Manufacturers, Thomas J. McHugh ... 135
National Association of Realtors, David D. Roberts and William Thurman ... 99
National Oil Jobbers Council, Michael T. Scanlon ... 172
National Remodelers Association/National Home Improvement Council, Randolph J. Seifert ... 89
Nolan, John S., Section of Taxation, American Bar Association ... 29
North American Van Lines, Inc., G. Zan Golden ... 194

Page
Offen, Neil, Direct Selling Association 105
Olson, H. Ted, Specialty Advertising Association International 175
Owner-Operators Independent Drivers Association, Mark Perry 202
Perry, Mark, Owner-Operators Independent Drivers Association 202
Rice, Grace Ellen, American Farm Bureau Federation 143
Roberts, David D., National Association of Realtors 99
Rolston, Kenneth S., Jr., American Pulpwood Association 145
Rothkopf, Arthur J., Direct Selling Association 105
Scanlon, Michael T., National Oil Jobbers Council 172
Schenken, Jerald R., M.D., American Medical Association 66
Seifert, Randolph J., National Remodelers Association/National Home Improvement Council, and Small Business Legislative Council 89
Shelter Insurance Co., Gustav J. Lehr 122
Small Business Legislative Council:
  Raymond J. Nall 83
  Randolph J. Seifert 89
Specialty Advertising Association International, John D. McNeer, H. Ted Olson, and Malcolm D. MacArthur 175
Thurman, William, National Association of Realtors 99
Young, Steven, Manufacturers' Agents National Association 132

SUBMISSIONS FOR THE RECORD

General Accounting Office, Daniel F. Stanton, statement 206

Abel, Harold, Central Michigan University, letter and attachment 230
American Council of Life Insurance, statement 209
American Horse Council, statement 212
American Insurance Association, Brenda R. Viehe-Naess, statement 214
American Newspaper Publishers Association, statement 215
American Petroleum Institute, statement 218
Associated Builders and Contractors, Inc., statement 223
Associated General Contractors of America, statement 226
Association of American Publishers, Inc., statement 228
Bannister, Robert D., National Association of Home Builders, statement 251
Barger, James D., M.D., College of American Pathologists, letter and attachment 234
Bedell, Hon. Berkley, a Representative in Congress from the State of Iowa, letter 230
Bernstein, Rachelle B., Chamber of Commerce of the United States of America, statement 232
Central Michigan University, Harold Abel letter and attachment 230
Chamber of Commerce of the United States of America, Rachelle B. Bernstein, statement 232
Cleaver, Wendell D., NICOR Drilling Co., letter 257
College of American Pathologists, James D. Barger, M.D., letter and attachment 234
Collins, Hon. James M., a Representative in Congress from the State of Texas, statement 236
Deizel, Mary Jo, Gibson, Dunn & Crutcher, letter and attachment 236
Dunham, Charles, Vacuum Dealers Trade Association, statement 269
George, Robert R., Penrod, George & Co., letter 258
Gephardt, Hon. Richard A., a Representative in Congress from the State of Missouri, statement 239
Gibson, Dunn & Crutcher, Mary Jo Deizel, letter and attachment 236
Gortikov, Stanley M., Recording Industry Association of America, Inc., letter .. 259
Henkel, Hackett, Edge & Fleming, Stanley H. Hackett, letter 240
Home Health Services & Staffing Association, John B. Smith, letter 241
Independent Insurance Agents of America, Inc., statement 243
International Franchise Association, statement 244
International Taxicab Association, Sigmund Zilbur, statement 246
Interstate Conference of Employment Security Agencies, Inc., statement 249
Maletta, Thomas P., Tax Executives Institute, Inc., letter 268
National Association of Home Builders, Robert D. Bannister, statement 251
National Association of Professional Insurance Agents, Dow Reichley and Nick A. Verreos, joint statement 255
NICOR Drilling Co., Wendell D. Cleaver, letter 257

Page

Parker Drilling Co., Robert L. Parker, Jr., statement 257
Penrod, George & Co., Robert R. George, letter 258
Recording Industry Association of America, Inc., Stanley M. Gortikov, letter 259
Reichley, Dow, National Association of Professional Insurance Agents, statement 255
Retail Floorcovering Institute, statement 260
Smith, John B., Home Health Services and Staffing Association, letter 241
Spectrum Emergency Care, Inc., statement 262
Tax Executives Institute, Inc., Thomas P. Maletta, letter 268
Vacuum Dealers Trade Association, Charles Dunham, statement 269
Verreos, Nick A., National Association of Professional Insurance Agents, statement 255
Viehe-Naess, Brenda R., American Insurance Association, statement 214
Zilbur, Sigmund, International Taxicab Association, statement 246

CLASSIFICATION ISSUES RELATING TO INDEPENDENT CONTRACTORS

FRIDAY, JUNE 11, 1982

House of Representatives,
Committee on Ways and Means,
Subcommittee on Select Revenue Measures,
Washington, D.C.

The subcommittee met at 10:05 a.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Fortney H. (Pete) Stark (chairman of the subcommittee) presiding.

Chairman **Stark**. The subcommittee will commence. I welcome you all.

Today we are taking testimony on a difficult but important issue: The classification of workers for employment tax purposes. The issue has had a long and controversial history in the past several Congresses regarding this legislation.

Congress has yet to achieve a satisfactory substantive solution. Rather, since the Revenue Act of 1978, interim relief has been provided to taxpayers who have a reasonable basis for treating workers as other than employees, and the Internal Revenue Service has been prohibited from issuing regulations and revenue rulings on common law employment status.

The interim relief and moratorium will expire on June 30. It is my hope that this hearing will make a positive contribution to our efforts to develop a rational and administrable solution to the independent contractor classification issue.

As I stated in the press release announcing this hearing, the subcommittee is considering only the classification issue today. Chairman Rostenkowski has already conducted a hearing on H.R. 6300, the Taxpayer Compliance Act, which contains provisions addressing the problem of compliance among nonemployees.

I must emphasize that Chairman Rostenkowski has only referred the classification issue to this subcommittee, and therefore I would ask witnesses to limit their testimony accordingly.

I might add at this point that, as we stated in the press release, we are going to ask the witnesses—and with the help of the blinking light—to hold their summaries to 5 minutes.

Their entire testimony will appear in the record. The record will stay open for sufficient time to allow everybody to add supplemental testimony or respond to questions in writing.

If any of the witnesses feel that they are denied adequate representation by being limited to 5 minutes, they may remain until the end of the hearing and the Chair will entertain additional verbal testimony at that point. I think this will be fair to all of the witnesses who have come a great distance and taken a lot of trouble to adhere to the rules that the subcommittee has put forward.

In connection with the classification issue, the subcommittee is particularly interested in discussion of the procedural aspects of retroactive reclassification of workers.

At this point, I would ask without objection that the press releases announcing this hearing and the previously scheduled hearings be made part of the record.

[The press releases follow:]

[Press release No. 11, February 26, 1982]

HON. FORTNEY H. (PETE) STARK, CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, ANNOUNCES PUBLIC HEARINGS ON LEGISLATIVE PROPOSALS RELATING TO INDEPENDENT CONTRACTORS

The Honorable Fortney H. (Pete) Stark (D., Calif.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced public hearings on legislative proposals relating to the classification of workers for Federal employment tax purposes on Tuesday, March 23, 1982, and Wednesday, March 24, 1982. The hearings will begin at 10:00 a.m. in 1100 Longworth House Office Building, the Committee's main hearing room. The lead-off witnesses at the hearings are expected to be the Honorable John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy), and the Honorable Roscoe Egger, Jr., Commissioner of the Internal Revenue Service.

In announcing these hearings, Chairman Stark stated that "It is imperative that the Subcommittee begin an examination of this issue and the various legislative solutions which have been proposed both in this Congress and the last, in light of the June 30, 1982, expiration of the statute providing temporary relief to taxpayers whose employment status was disputed, and of the moratorium on the issuance of regulations and rulings in this area by the Internal Revenue Service."

BACKGROUND

Section 530 of the Revenue Act of 1978 (Public Law 95-600) provides interim relief from potentially large assessments, resulting from the Internal Revenue Service's proposed reclassification of workers who have been involved in employment tax status controversies. Specifically, the Revenue Act of 1978: (1) Terminated certain potential employment tax liabilities for periods ending before January 1, 1979; (2) allowed taxpayers who had a reasonable basis for classifying certain workers as independent contractors in the past to continue such treatment for periods ending before January 1, 1980; and (3) prohibited the issuance of Treasury regulations and revenue rulings with respect to the common law classification of workers prior to January 1, 1980.

This temporary interim relief and prohibition on the issuance of new rulings and regulations by the Internal Revenue Service was extended through December 31, 1980, by Public Law 96-167 and through June 30, 1982 by Public Law 96-541.

In the 96th Congress, the Subcommittee on Select Revenue Measures held extensive hearings on this issue and favorably reported H.R. 5460, the Independent Contractor Tax Act of 1979, to the full Committee. However, no action was ever taken by the full Committee prior to the adjournment of the 96th Congress.

H.R. 5460 would have provided a new statutory safe harbor for determining when an individual would be classified as an independent contractor. To qualify as an independent contractor under this test, five requirements would have to be met. These requirements involve control of hours worked; existence of a principal place of business, an investment in assets, or engaging in sales; income fluctuation; written contract and notice of tax responsibilities; and filing of required returns.

In addition, H.R. 5460 would have imposed a flat 10 percent rate of withholding on payments made to certain independent contractors. The bill would have provided new requirements for filing information returns with respect to payments made to independent contractors and with respect to sales of $3,000 or more of consumer products to any individual for purposes of resale. Increased penalties for failure to file or withhold would also have been imposed.

In the 97th Congress, H.R. 4531 (Mr. Conable) and H.R. 4971 (Mr. Philip M. Crane) have been introduced to provide a permanent set of rules governing the classification of individual workers for purposes of Federal employment taxes.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Individuals and organizations interested in presenting oral testimony at the hearing should submit their requests to be heard by telephone to be followed by a formal written request, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515; telephone: (202) 225-3627. The initial telephone request must be received by the Committee not later than the close of business Friday, March 12, 1982. Notification to those scheduled to appear will be made by telephone as soon as possible after the filing deadline.

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Subcommittee to hear as many points of view as possible. Time for oral presentation will be strictly limited, with the understanding that a more detailed statement can be submitted for the Subcommittee's review and for inclusion in the printed record of the hearings. This will afford more time for interrogation of the witnesses by the members of the Subcommittee. If it becomes necessary, the staff will group the witnesses into panels to expedite the hearings and will establish strict time limitations for each panelist.

PROCEDURES TO BE FOLLOWED FOR SUBMITTING TESTIMONY

The following is an outline of the procedure to be followed by organizations and individuals who may either want to appear and testify during the hearing or file a written statement for the printed record of the proceedings. All requests to be heard should also contain the following information:

1. The name of the witness, title, address, firm affiliation and/or organization he will represent (as well as a telephone number where his or her designated representative may be reached).
2. If appearing in an individual capacity, a list of any clients at whose request or in whose employ the witness appears.
3. A topical outline or summary of comments and recommendations.

The above information should also be incorporated in the prepared statements to be presented in person as well as those filed for the record.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, witnesses scheduled to appear before the Subcommittee should comply with the following rules:

1. All witnesses must submit 40 copies of their prepared statement to the full Committee office, Room 1102, Longworth House Office Building, not later than noon on Monday, March 22, 1982.
2. Witnesses should not read their written statements to the Subcommittee, but should instead limit their oral presentations to a summary of the points included in the statement.
3. Not more than five minutes will be allowed for the oral summary.

Failure to comply with these requirements may result in the witnesses being denied the opportunity to testify in person or being deferred until all other testimony is heard.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, five copies are required and must be submitted by the close of business, Wednesday, April 7, 1982, to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office the day before the hearing.

[Press release No. 12, March 19, 1982]

HON. FORTNEY H. (PETE) STARK, CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS ANNOUNCES THE POSTPONEMENT OF PUBLIC HEARINGS ON LEGISLATIVE PROPOSALS RELATING TO INDEPENDENT CONTRACTORS

The Honorable Fortney H. (Pete) Stark (D., Calif.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced the postponement of public hearings on legislative proposals relating to independent contractors, which were originally scheduled for Tuesday, March 23, 1982, and Wednesday, March 24, 1982. (See Press Release No. 11).

Chairman Stark stated that the hearings were being postponed at the request of the Department of the Treasury and would be rescheduled at a later date.

[Press release No. 15, May 13, 1982]

HON. FORTNEY H. (PETE) STARK, CHAIRMAN, SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS ANNOUNCES PUBLIC HEARINGS ON CLASSIFICATION ISSUES RELATING TO INDEPENDENT CONTRACTORS TO BE HELD ON FRIDAY, JUNE 11, 1982

The Honorable Fortney H. (Pete) Stark (D., Calif.), Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, today announced that public hearings on issues relating to the classification of workers for Federal employment tax purposes, previously scheduled for March 23, 1982, and March 24, 1982 (see press release No. 11), will begin on Friday, June 11, 1982. The hearings will begin at 10:00 a.m. in 1100 Longworth House Office Building, the Committee's main hearing room. The leadoff witnesses at the hearings are expected to be the Honorable John E. Chapoton, Assistant Secretary of the Treasury for Tax Policy, and the Honorable Roscoe Egger, Jr., Commissioner of the Internal Revenue Sevice.

In announcing the re-scheduling of these hearings, Chairman Stark stated that "it is imperative that the Subcommittee resolve the issue of the classification of workers for employment tax purposes, in light of the June 30, 1982, expiration of the statute providing temporary relief for taxpayers whose employment status was disputed, and expiration of the moratorium on the issuance of regulations and rulings in this area by the Internal Revenue Service."

Witnesses are asked to address the classification issue in their testimony, particularly the procedural aspects of reclassifications for employment tax purposes.

In an earlier Subcommittee press release, a deadline was given for making requests to appear in person at the hearing. That deadline has passed and the Subcommittee will not take any further requests to testify. However, submissions for the record received by close of business, Monday, June 14, 1982, will be included in the Subcommittee's official hearing record.

Chairman STARK. Unless any other members of the committee, my distinguished ranking minority member, Mr. Duncan, has a statement, we will proceed with our first witness, the Honorable John E. Chapoton, Assistant Secretary for Tax Policy, accompanied by Mr. Roscoe L. Egger, Jr., Commissioner of the Internal Revenue Service.

Welcome, gentlemen. Proceed as best you can in 5 minutes.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, ACCOMPANIED BY HON. ROSCOE L. EGGER, JR., COMMISSIONER OF INTERNAL REVENUE

Mr. CHAPOTON. Thank you, Mr. Chairman.

I will be very brief, and we will be happy to answer any questions.

First, let me state that we welcome these hearings. As we all know, the moratorium on reclassification and issuance of regulations and rulings in this area expires June 30 of this year, so it certainly is appropriate that we address this very complex problem.

In dealing with the employee-independent contractor issue, our principal concern has been, and is, the low compliance that these taxpayers, as a group, have shown with respect to both income taxes and Social Security taxes. I mention in my prepared testimony the IRS study that bears that out. We are concerned about that factor.

The focus of this hearing, as the chairman states, is not compliance, but compliance is necessarily intertwined in our considerations today.

The specific controversy over independent contractors has focused on the definition of the term "independent contractors." We should keep in mind that if we correctly define that term, we are still going to be faced with the best method of achieving compliance within the group of taxpayers who fall within the definition, safe harbor or nosafe harbor, and are independent contractors. Thus, we must deal with the compliance area for that group.

Under common law, workers are considered employees if the person for whom the services are performed has the right to control and direct the individual. Common law has some 20 factors that are applied, and thus the question turns on the specific facts of the individual case, and a great deal of uncertainty remains.

Although the tax dispute has been cast in terms of whether the payor has the right to exercise control of the worker, that historical development is not necessarily determinative of whether withholding at graduated rates is appropriate for a particular worker.

We think that if a worker's gross remuneration approximates his net income, withholding at the graduated rates would accurately collect the correct amount of tax and would be the least disruptive for the worker.

Where his net income departs substantially from his gross income, the current system of withholding would produce over withholding and probably would not be an accurate or desirable tax collection method.

In determining or looking at a particular safe harbor definition of independent contractor, the elements of that safe harbor should attempt to isolate and cover the cases in which withholding on gross remuneration would not be sensible.

Items such as substantial investment or unreimbursed expenses are key, while conditions of employment or control over those conditions, even though they often indicate independence, may not be determinative or even germane, except to show the administrative feasibility of withholding.

Turning to the bills, there are five bills before this subcommittee. We want to express concern that four out of five of the bills establish a safe harbor that in our judgment is broad enough to encompass virtually all of the cases in dispute at the enactment of the moratorium, while the fifth in effect guarantees safe harbor treatment to certain of them.

We think safe harbor treatment that broad could exacerbate the serious compliance problem that we see under current law.

The bills all have elective statutory safe harbors, which apply only where the service recipient supplies a written contract and notice of tax responsibilities to the worker and only if the service recipient complies with the information reporting requirements.

We certainly support these procedural requirements of the legislation and would support them whatever safe harbor is adopted.

Basically these bills have three tests, though they vary in details: One is the control of hours worked test; the second is a place of business test; and the third is the investment or income fluctuation test.

I go through in our prepared statement, Mr. Chairman, each of these tests and raise questions about some of them, but let me just summarize by saying that we would support a retention of common law and a safe harbor test. However, we think the safe harbor must be tailored to include only those taxpayers for whom withholding would be most inappropriate.

We think that if an individual is paid on other than an hourly or salaried basis and meets any of the following three conditions; that is, he maintains a principal place of business or has substantial assets used in connection with his business, or incurs substantial unreimbursed expenses of a particular type, such as payroll, supplies, or cost of goods sold, he clearly would be an independent contractor. These factors would constitute an appropriate safe harbor.

I see my time has expired, Mr. Chairman. Let me just also say that we deal with the problem of retroactive assessment in our prepared testimony. We do think that an undue penalty does exist under existing law.

We would like to work with the committee in fashioning a lower flat-rate type penalty that would be an approximation of the tax due, and would avoid the substantial assessment and the substantiation question of exactly how much tax was paid by someone who turns out to be an employee when the service recipient thought they were an independent contractor.

[The prepared statement follows:]

JOINT STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY (TAX POLICY), AND HON. ROSCOE L. EGGER, JR., COMMISSIONER OF INTERNAL REVENUE, DEPARTMENT OF THE TREASURY

Mr. Chairman and Members of this Subcommittee:

We are pleased to be here today to present our views on classification issues related to the status of individuals for employment tax purposes.

We wish to commend the Members of this Subcommittee for holding hearings on this important subject. Because the moratorium on the reclassification and issuance of regulations and rulings in this area expires on June 30, 1982, renewed consideration of this issue is imperative. The present moratorium has only delayed a solution to the problem. Both taxpayers and tax administrators will benefit from its resolution.

OVERVIEW

In dealing with the employee-independent contractor issue, our principal concern is the low compliance that independent contractors as a group have shown with respect to both income and social security taxes. Noncompliance with our tax laws is a serious and growing problem. In this time of unprecedented fiscal austerity, we must take all available measures to prevent taxpayers from underreporting their income or overstating deductions or exemptions claimed on filed returns.

In 1979, the Internal Revenue Service undertook a study of the income tax and social security tax compliance of independent contractors. This 1979 Employer/Independent Contractor Compliance Study has been the subject of much discussion and criticism. Even if the criticism were justified, however, the results of that study indicate such significant noncompliance that its basic conclusion cannot be overlooked.

The 1979 study showed substantial underreporting for income tax purposes and even greater underreporting for social security purposes among those workers studied. For income tax purposes, about 78 percent of the income that should have been shown on returns was reported. In terms of taxes due, the 78 percent of reported income resulted in the collection of about 85 percent of the total tax liability due. Thus, approximately 22 percent of the income that should have been reported -- more than $1 out of each $5 -- was not reported, and 15 percent of income tax liabilities was not paid. Significantly, almost 45 percent of the workers in the study reported absolutely none of the income they earned as to which there was no withholding. As these figures indicate, nonreporting predominantly occurred among workers with smaller amounts of payments.

With respect to social security taxes, noncompliance was even greater. In total dollar terms, 69 percent of income was reported and 69 percent of social security taxes due were paid; thus noncompliance was 31 percent. Most disturbing, however, 58 percent of the workers did not report any of their self-employment income for social security purposes.

We cannot afford this high rate of noncompliance among independent contractors. Compliance measures do not impose new taxes; they merely ensure collection of taxes otherwise due. While the question of compliance among independent contractors is not the focus of this hearing, nonetheless improving compliance is and should be the goal of any legislation in this area. Our views on various compliance measures were presented before the full Committee in our May 18, 1982, testimony on H.R. 6300, Title II of which would improve information reporting by nonemployees.

The controversy over independent contractors, however, has focused on another question: what is the definition of "independent contractor"? While this question is linked to compliance, the two issues are not identical -- if we correctly define the term "independent contractor," we still are faced with the question of achieving the best compliance within that group.

DISCUSSION OF CLASSIFICATION PROPOSALS

Definition of Independent Contractor and Safe Harbor Tests

Under the Internal Revenue Code, compensation is subject to withholding of income and employment taxes only if an employer-employee relationship exists under common law. Also, social security (FICA) and Federal unemployment (FUTA) taxes are due only if such employer-employee relationship exists. For income tax purposes, an employee is subject to withholding at graduated rates, while a self-employed individual makes quarterly estimated tax payments and the payor does not withhold. It is this disparity in collection which has put such pressure on the definition of independent contractor.

A worker is considered an employee under the common law when the person for whom services are performed has the right to control and direct the individual, not only as to the result but also as to the details and means by which the result is to be accomplished. Some 20 factors are applied to determine whether the requisite control exists; thus, determinations of employment status are heavily dependent on the specific facts of the individual case.

In many cases applying the common law test in employment tax issues does not yield clear, consistent, or satisfactory answers and reasonable persons may differ as to the correct classification. Common law concepts initially developed in England as a way to determine when a master would be liable for the torts of his servant. Different criteria for determining control have been emphasized by different courts, so that no one factor is deemed to be determinative.

Although the independent contractor dispute has been cast in terms of whether the payor has the right to exercise control of the worker, that historical development need not be determinative of whether withholding at graduated rates is appropriate for a particular worker. If a worker's gross remuneration approximates his net income, withholding at graduated rates would accurately collect the correct amount of tax. Indeed, from the standpoint of the worker, withholding is the most convenient and least disruptive method of satisfying his tax obligation. On the other hand, if a worker's net income departs substantially from his gross income, the current system of withholding would produce overwithholding and would probably not be an accurate or desirable tax collection method. Moreover, if an individual works for many payors, withholding, to be accurate, presents administrative problems.

If a safe harbor definition of independent contractor will exempt a worker from the withholding system applicable to employees, the elements of that safe harbor should attempt to isolate and cover cases in which withholding on gross remuneration would not be sensible. Items such as substantial investment or unreimbursed expenses are key, while conditions of employment and control over those conditions, even though they often indicate independence, may not be determinative or even germane, except to show the administrative feasibility of withholding.

The relationship between a safe harbor and retention of common law is also crucial. A statutory safe harbor, properly drawn, would provide certainty as to their independent contractor status to workers and those for whom they perform services. But no safe harbor, however well conceived, could purport to cover all independent contractor relationships without sweeping into the safe harbor many people who are clearly employees, as well as many others whose status may be debatable. In our view the common law provides sufficient flexibility to deal with a myriad of work relationships.

A balanced approach to classification, then, should provide an appropriate but narrow safe harbor while retaining the common law to deal with taxpayers who do not meet the specific statutory provisions. We would like to comment on the classification aspects of the various proposals before this Subcommittee. At the outset, we are concerned that four out of the five bills establish a safe harbor that in our judgment is broad enough to encompass virtually all cases in dispute at the enactment of the moratorium, while the fifth in effect guarantees safe harbor treatment to certain of them. This could exacerbate the serious compliance problem that exists under current law.

Factors Proposed in Bills

Each of the five bills, H.R. 6311, H.R. 5867, H.R. 4531, H.R. 5729, and H.R. 4971, deals with the classification issue by establishing a statutory safe harbor. The provision is elective; it generally applies only where the service-recipient supplies a written contract and notice of tax responsibilities to the worker prior to the service being performed and only if the service-recipient complies with information reporting requirements.

In addition, the bills provide other tests which a worker must meet to be within the safe harbor. Although each bill has slight variations unique to it, the tests fall into the following broad categories:

(1) Control of hours worked test -- The individual must control the aggregate number of hours worked and substantially all of the scheduling of the hours worked.

(2) Place of business test -- If the individual has a principal place of business, it cannot be provided by the service-recipient unless the individual pays rental for it (under H.R. 6311, a "fair" rental must be paid, and incidental use of the service-recipient's premises will not disqualify an individual).

(3) Investment or income fluctuation test -- The individual must either (a) have a substantial investment in assets used in performing the service (under H.R. 6311 they must be tangible assets which are of significant value in the performance of the service and a substantial economic investment in light of the remuneration received), or (b) risk income fluctuation because more than 90 percent of the remuneration is directly related to sales or other output rather than to the number of hours worked (H.R. 5729 and H.R. 4971 contain no 90 percent measure; H.R. 5867 increases the percentage to 95 percent after 1983).

Under H.R. 5867 an individual must meet a control of hours test and an income fluctuation test similar to those in the other bills. However, H.R. 5867 structures its test relating to investment as a place of business, assets, or type of sales test. The difference in the place of business component in this bill is that the principal place of business cannot be provided by the service-recipient, and, if it is in the individual's home, it must be exclusively used on a regular basis. The assets test, unlike the ones in the other bills, assigns a statutory minimum under which more than one-third of the value of the service provided must be attributable to certain assets furnished by the individual and, except for truck-tractors, assets must not be financed by, or leased from, the payor. Lastly, H.R. 5867 introduces a new alternative in the investment test that explicitly includes insurance agents, licensed real estate agents, and persons engaged in direct sales activity within the safe harbor, provided the control of hours and income fluctuation tests are met.

H.R. 4971, on the other hand, provides two additional safe harbors. Any individual with a "substantial" investment in assets is afforded safe harbor treatment where the assets are owned or leased under a bona fide arrangement, and the individual, who also is responsible for supplying necessary personal services, provides maintainance and bears the "principal burden" of all operating costs. The failure to file returns does not affect this safe harbor. Finally, any individual who merely performs similar services for five or more payors during the year would be entitled to safe harbor treatment; no written contract would be required, and no other tests need be satisfied.

I would like to comment on each of the tests in these bills.

Control of Hours Worked Test. The tests making up a safe harbor should be designed to indicate whether withholding on a worker's gross remuneration is accurate. In our view control of a worker's hours is seldom relevant to this determination; nevertheless, it is an important factor under common law and is not inappropriate to include in a safe harbor.

H.R. 6311 and H.R. 4531 provide that an individual can satisfy the control of hours test even though control may be limited as a result of (i) government regulations, operating procedures and specifications with which the service-recipient must comply, or (ii) coordination of the services with other services so long as such coordination is done by a person other than the service-recipient. H.R. 6311 also permits control of access to premises by the service-recipient. With these qualifications, the control of hours test is easily met in most instances. The line between control of hours and control of access to premises or work sites can be a fine one. If a safe harbor is to be clear and easily administered -- that is, safe -- the tests for it must be relatively objective. Control of hours is difficult to determine and subject to manipulation. If this test is included, it should be more tightly drawn.

Place of Business Test. We agree that an investigation of a taxpayer's investment in his business can be a surrogate for determining whether his gross remuneration approximates his net income. We thus agree that a place of business test is appropriate, provided that the test is met only if there is a place of business which represents a substantial investment. If the place of business is at the taxpayer's home, we believe it must explicitly qualify under section 280A of the Code. Furthermore, the place of business should be separate from that of the service-recipient, as required in H.R. 5867. Allowing an individual to satisfy the safe harbor by a place of work that is provided by the service-recipient could be subject to manipulation, even where some form of rent is required. Many existing compensation arrangements could easily be modified to meet this requirement. At the very least, an arm's length standard should apply. H.R. 6311, for example, would require that "fair rental" be paid. This standard should be clarified so that a percentage of commissions, for example, could not be designated as fair rental, and that a fixed dollar payment would be needed as an indication that the payee bore some risk.

Investment or Income Fluctuation Test. The third test of the safe harbor rules in H.R. 6311, H.R. 5729, H.R. 4531, and H.R. 4971 is one designed to determine whether a worker is "economically independent" because he has a substantial investment in assets or because he risks income fluctuation.

We do not agree with the approach in H.R. 4971 that an assets test alone guarantees safe harbor treatment. The assets test in H.R. 5867 is an alternative to the place of business test, presumably on the theory that either represents a significant investment. This standard, which measures the investment against one-third the value of the services, presents significant allocation problems. We believe that the investment in assets test in H.R. 6311 provides sufficient flexibility to cover instances in which individuals have substantial capital invested in their businesses. While we would permit situations in which the property either is leased from or financed by the service-recipient, it is important that these instances be carefully circumscribed, so that only arm's length arrangements could meet this test. Thus, a lease term must be significant in relation to an asset's useful life; assets which are leased on a short-term or per job basis should not be taken into account; and the rent for the assets must be a fixed, arm's length amount.

Turning to the income fluctuation test, it should be made clear that if remuneration is provided in the form of guaranteed amounts, reimbursed expenses or other benefits, this test could not be met. The test is meaningful if it is a proxy for determining whether the worker bears risk of loss in a significant way. In our view, this test must contain a percentage requirement of at least 90 percent to insure that result. This would be consistent with the stated goal of these safe harbors, that is, to provide certainty to taxpayers.

More important, though, are compliance considerations. If the worker bears a risk of loss but does not have significant unreimbursed expenses, withholding under the current system may be feasible, especially if the worker has a continuing relationship with a single payor. This could be true if the taxpayer's occupation is not subject to cyclical downturns or other recurring events that would cause his income to fluctuate widely within a year. We think that a more meaningful test would be the amount of the individual's unreimbursed expenses of a particular type, such as payroll expenses, supplies, or the cost of goods sold, in relation to his income. Where a worker has substantial unreimbursed expenses which would cause withholding to overstate his periodic tax payments, safe harbor treatment would be justified.

Type of Sales Test. H.R. 5867 would extend safe harbor treatment even where an individual had no significant investment in his or her business, so long as that individual met the control of hours and income fluctuation tests and was either an insurance agent, licensed real estate agent, or direct seller. We think it is inappropriate to carve out these specific categories of taxpayers for favorable treatment regardless of whether they have any investment in the business or work on premises supplied by the service recipient.

Multiple Payors Test. We recognize that where an individual works for more than one payor, imposing withholding on remuneration raises administrative concerns with overwithholding. However, even under current law employees can adjust wage withholding to deal with this problem, and the Economic Recovery Tax Act of 1981 increased the flexibility of the withholding system to avoid overwithholding. We thus reject the notion that a test that looks solely to the number of payors should stand apart from any other factors in providing safe harbor treatment.

To summarize our position, we support the retention of common law and a safe harbor, but the safe harbor must be tailored to include only those taxpayers for whom withholding under the current system would be most inappropriate. We think a preferable safe harbor would be one covering only cases in which an individual is paid on other than an hourly or salaried basis and meets one of the following conditions: The worker (1) maintains a principal place of business, including a part of the home qualifying under section 280A of the Code, (2) has substantial assets used in connection with the performance of the services, or (3) incurs substantial unreimbursed expenses of a particular type, such as payroll expenses, supplies, or the cost of goods sold, in performing the services. We also would adopt the requirements of written contracts, notice, and compliance with information reporting.

Further, we would require an "anti-switching" rule, which would prevent employers who have treated their workers as employees under current law from switching these workers to independent contractor status merely because insubstantial changes in the employment relationship could qualify under the safe harbor adopted. The possibility of switching demonstrates how important it is to craft any safe harbor carefully. However, it will not be possible even under the best circumstances to anticipate every relationship. Therefore, some protection must be provided to prevent employees with an inferior bargaining position from being switched to independent contractor status by their employers. H.R. 6311 recognizes this problem by providing a transition rule that would prevent this type of switching before January 1, 1983. It is appropriate that this type of switching be prevented permanently.

In addition to providing a safe harbor test, the various bills contain several special rules. First, they provide that relationships failing to meet the safe harbor test would be classified under common law rules, as if the safe harbor test were not enacted. We agree that failing the safe harbor test should not create a presumption against independent contractor status.

Next, the bills provide that the safe harbor will not apply to any individual described in section 3121(d)(3) of the Code (that is, certain agent-drivers, commission-drivers, full-time life insurance salesmen, home workers, and traveling or city salesmen). Thus, these workers would remain employees by statute for social security purposes, while their status for income tax withholding would be determined under the common law. Both H.R. 4531 and H.R. 5867 would extend employee treatment for these workers to income tax withholding as well. We agree that the long-standing employee status of these workers for social security tax purposes should continue, and we see merit in treating them similarly for income tax purposes.

The bills also provide that qualification as an independent contractor under the safe harbor test for purposes of Federal employment taxes and withholding would create no inference with respect to other laws. This is appropriate, since the policies behind state unemployment compensation laws or labor relations acts may be very different from the policies for Federal tax purposes, even though these statutes may in many instances also rely on common law rules. However, it should be recognized that, because of the relationship between state unemployment statutes and the Federal Unemployment Tax Act, there will be a strong influence on the states to conform their laws, despite the existence of a "no inference" clause.

Finally, under H.R. 6311, H.R. 5867, and H.R. 4531, individuals who qualify under the safe harbor as independent contractors would be denied statutory employee benefits, including the exclusion for employer provided group term life insurance, death benefits, accident and health benefits, group legal services, education assistance plans, and pension, profit-sharing, stock bonus or annuity plans. H.R. 6311 and H.R. 4531 expressly provide that these individuals would be eligible for Keogh plans, however. Again, this is an appropriate recognition that independent contractors are self-employed businesses and that employee benefits should not be available. Consideration should be given to adding the exclusion for meals and lodging provided for the convenience of the employer to the list of benefits unavailable to independent contractors.

PROCEDURAL ISSUES IN EMPLOYMENT TAX AUDITS

When the Internal Revenue Service determines on audit that workers should have been classified as employees rather than as independent contractors, the employer is liable for the employer share of Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) payments and for the income and FICA taxes which should have been withheld from the employee, for all past years for which the statute of limitations has not expired. In addition, reclassification could call into question the status of the employer's pension plan. Furthermore, the liability for income taxes which should have been withheld can be abated only if the payor can prove that the workers had in fact paid their income taxes, which frequently is impossible because in many instances the workers cannot be located. Even when workers can be located, the burden of establishing that they paid their tax liability for the years at issue often is time consuming and costly. Moreover, the payor's liability for FICA taxes which should have been withheld cannot be offset by any Self-Employment Contributions Act (SECA) taxes paid by the worker (assuming the SECA tax had in fact been paid), unless a worker is barred from filing a claim for refund by the statute of limitations. As a result, liabilities for taxes not withheld can result in more than the actual tax liability being collected, but neither the payor nor the Internal Revenue Service has an adequate means for determining how to abate the tax.

All tax assessments in our system are, and should be, retroactive. However, the SECA and income tax offset requirements in employment tax cases present severe problems of proof. One approach to be considered in reclassification cases is to limit the taxpayer's liability upon reclassification to the FUTA tax, the employer portion of the FICA tax, plus a flat percentage of wages which would approximate the income and employment taxes that should have been paid by the employee. This percentage amount would be in lieu of actual taxes owed. The percentage should not be determined on a taxpayer-by-taxpayer basis; rather, it should yield a realistic approximation of the liabilities in this area, with an attempt to avoid excessive overpayments. While a compromise on accuracy, this method would avoid the need for establishing offsets. We are hesitant to establish any precedent for abating retroactive assessments, but this type of provision would represent a significant improvement for both taxpayers and the Service because of the recordkeeping problems under current law. It may be appropriate as well to use a lower percentage to compute the amount owed by taxpayers who comply with all reporting requirements.

We caution that any percentage cannot be set too low or its use will erode the consequences of inappropriate classification to such an extent that employers will be willing to take the risk of misclassifying workers. We would be happy to work with this Subcommittee to consider further an appropriate provision in this area.

Of the bills before this Subcommittee, only H.R. 4531 deals directly with the procedural aspects of employment tax cases. This bill would provide Tax Court jurisdiction over reclassification disputes. Extending the Tax Court jurisdiction to employment tax cases would be very unwise. The Tax Court docket is already vastly overburdened. Existing procedures in employment tax cases already provide access for taxpayers to the Court of Claims or district courts based upon payment of a small fraction of the amount actually at issue. Providing Tax Court jurisdiction would not facilitate review.

Moreover, the advantage of employee status under the social security laws is retroactive. A worker determined to be an employee can receive credit for wages for employment covered under social security regardless of whether FICA taxes have been withheld or paid. Thus, postponing liability until a Tax Court proceeding is resolved in some cases could prove costly should the amounts in dispute ultimately prove uncollectible. This result does not obtain in employment tax refund suits under current law because the Service can file liens against the taxpayer, which it cannot do in Tax Court litigation. For these reasons, we oppose Tax Court jurisdiction over classification disputes.

SUMMARY

In dealing with the employee-independent contractor issue, our principal concern remains compliance. The Treasury Department supports the adoption of a safe harbor provision to clarify the tax status of workers for employment tax purposes, if this provision is carefully drawn and accompanied by significantly increased compliance measures. With such a safe harbor, we think that the common law is adequate to deal with workers in all other instances, and relief from retroactive assessments should be considered.

Chairman **Stark**. Thank you, Mr. Secretary.

Following up on that, would you anticipate in the retroactivity area that there would be some kind of relief for people who thought they were acting in good faith?

Mr. **Chapoton**. I think where 1099 reporting was complied with, for example, there ought to be an easier penalty. We would even think about going beyond that because we have a difficult problem here, and I think one of the things that has really caused a controversy is the inability of the service recipient to show that the independent contractor or the person he thought was an independent contractor actually paid the tax.

So, we might have a penalty that would approximate tax liability. Even where there was not information reporting, we might have a lessened penalty than would exist under existing law, and where there was compliance with information reporting an even lower penalty than that.

Chairman **Stark**. The Chair would also like to, without objection, make your 1979 compliance study part of the record.

Mr. **Chapoton**. That would be fine.

[Material in subcommittee files.]

Chairman **Stark**. It has been commented on by people affected by this legislation. I wonder if you and Commissioner Egger could comment on the plans you now have, if any, or on what you intend to do upon the expiration of the moratorium on June 30.

I think it is realistic to think that the legislation may not get passed. We all have other pieces on our legislative smorgasboard that we are going to have to deal with rather quickly, and this legislation may not be completed by then.

Do you have plans?

Mr. **Chapoton**. We have discussed that. I think the Commissioner can talk about that.

Mr. **Egger**. Basically this is an IRS problem. Let me dispel any fears immediately by saying that we are not going to do anything precipitously. Moreover, we think that solving the problem is much more important than dealing with any particular individual case. So, we want to move slowly, we want to move deliberately, mainly to give the Congress every opportunity to complete its own analysis of the problem and to take whatever action it sees fit to take.

Should that not come about, then I would anticipate that we would tend to move in the general direction of Mr. Chapoton's testimony; namely, what we would like to see is some sort of a safe harbor set of rules, fairly sharply defined, so that they would be easy to apply and easy to follow, coupled with the common law tests in those cases that do not fall within the safe harbor.

Something of that sort, we believe, is a good sound way to approach this problem, and so we would expect to do that with ample opportunity for public comment, and for suggestions or comment by members of this subcommittee.

For example, we are not anxious to see another extension of section 530. That is not, in our judgment, a way of solving the problem. It simply puts it off.

Chairman **Stark**. Thank you very much.

Mr. Duncan?

Mr. Duncan. Mr. Commissioner, you are rather indefinite as to the time or as to how you are going to handle this issue. Would you come back to us before you do something? Would you consult with the committee?

Mr. Egger. I would be most happy to do that. In fact, I said earlier that I would hope that the solution would come out of some of this proposed legislation, and we would like to work with the subcommittee to move in that direction.

Mr. Duncan. Do you anticipate giving the committee reasonable time, if we desire?

Mr. Egger. Yes, absolutely.

Mr. Duncan. Before you actually move out?

Mr. Egger. I am anxious to see the problem solved. I am not anxious to jump into cases or anything of that sort.

Mr. Duncan. Mr. Chapoton, I just have one question.

You alleged that the independent contractors have low tax compliance. I wonder what sampling and methodology you used to support the claim. Are you still using the claims based on the studies of the Carter administration, which were discredited soon after they were released? Are you still using that or do you have something new?

Mr. Chapoton. No, that study has been reviewed much more closely. I think one of the major complaints was it did take cases where there was noncompliance at the service recipient level, and the complaint was that that selected the bad cases.

I don't think, on the other side, that that would necessarily indicate that the service provider or alleged independent contractor should be complying with the tax law less because of the payor's noncompliance.

We don't feel we have to stand or fall on those exact figures. We think that information, though, showed a serious problem. We think we must deal with it.

Mr. Duncan. Would you anticipate that you will make a new study in light of the testimony in previous hearings, which discredited the Carter studies? I mean, there was no question. Perhaps even the administration didn't mind. Are you making new studies?

Mr. Chapoton. We have no plans to make a new study at Treasury.

Mr. Egger. We are reviewing the study; that is, the methodology used, Mr. Duncan, to assure ourselves that we are not grossly misstating in any way the conclusions, but at the moment we do not have plans for any additional study.

Again echoing Mr. Chapoton's comment, the indications are that there is a problem, and we are more interested in solving the problem than we are trying to arrive at a number that everybody agrees on.

Mr. Duncan. In your retroactivity, will you consider what has been customary and normal in a particular business line. For example, homebuilders often contract out the plumbing, the roofing, the painting and the like? Will you consider that?

Mr. Chapoton. In my statement where we mention that we really haven't developed that very far. I think the first step would be to lessen the blow for a misjudgment on the part of the payor, on whether the payee is an independent contractor.

Now, the law requires a real sledge hammer effect, and we think it would be good to remove that, but on the details we need to work with the subcommittee.

Mr. DUNCAN. Thank you both, and thank you, Mr. Chairman.

Chairman STARK. Thank you, gentlemen.

We may have additional questions. We will submit questions in writing for the record.

Mr. DUNCAN. May I ask that we may submit questions to all witnesses in writing?

Chairman STARK. Without objection, we will keep the record open sufficient time for them to respond for the record.

Thank you both.

Mr. CHAPOTON. Thank you, Mr. Chairman.

Chairman STARK. Our next witnesses constitute a panel: Mr. Stephen Koplan, American Federation of Labor and Congress of Industrial Organizations; Mr. John S. Nolan, chairman of the Tax Section of the American Bar Association; Dr. Jerald R. Schenken, member of the American Medical Association Council on Legislation; Mr. Raymond J. Hall, executive vice president of the Electronics Representatives Association, accompanied by Mr. Randolph J. Seifert, general counsel, National Remodelers Association, National Home Improvement Council.

Identify yourself for the reporter so he knows who each of you are and can ascribe the testimony to the proper individual as you proceed.

I will call upon you in the order in which you appear on the witness list, but if you wish to proceed in any other order, you may. Your entire testimony will appear in the record, and I will ask you to summarize it.

Mr. Koplan, would you like to proceed.

STATEMENT OF STEPHEN KOPLAN, LEGISLATIVE REPRESENTATIVE, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. KOPLAN. Thank you, Mr. Chairman.

The AFL–CIO urges this committee to narrowly limit the use of the independent contractor status so that employers will be discouraged from circumventing their responsibilities and contributing to the exploitation of workers.

Apart from the tax equity issue, the AFL–CIO is concerned that the final version of the bill could serve as a means for unscrupulous employers to manipulate the form of employee work relationships, so as to benefit by having those employees classified as independent contractors.

Unless such machinations are prevented, employees will find themselves reclassified and excluded from job protections they now enjoy.

For example, if reclassified as independent contractors, employees lose their eligibility for benefits under the unemployment compensation program. These workers are also required to pay social security taxes at the higher self-employed rates. They do not have withholding for income tax purposes, and they lose opportunities for collective bargaining.

Whether a worker is classified as an employee or as an independent contractor could affect how that worker is treated under other laws. For example, many state income tax laws parallel Federal tax law, and State income tax withholding generally coincides with Federal withholding rules.

State unemployment compensation benefits depend upon whether workers were treated as employees and whether Federal Unemployment Tax Act taxes were paid on their wages. Also, the Federal minimum wage applies to a worker classified as an employee.

State minimum wage laws are similar. In addition, the reclassification of workers in firms in which some were treated previously as employees and others as independent contractors could alter the proper determination of bargaining units under labor relations laws.

Equally important, laws safeguarding work places establishing standards for working conditions, providing workers' compensation, and affording protection from discrimination in hiring, promotion and benefits apply to workers only if they are classified as employees and not if they are classified as independent contractors.

Even though a Federal employment tax status reclassification is not binding for purposes of other laws, it could be a signal to administrators that the application of other laws is at issue.

In sum, American workers and their families have a vital interest in the final outcome of these hearings that far transcends tax considerations.

The enormity of noncompliance in this area is shocking. In order to capture the lost revenue, promote tax equity and resolve the classification problem, we urge that the existing system for withholding on employees at graduated rates be expanded to independent contractors and clear-cut classification criteria be developed.

In 1979, the AFL-CIO endorsed criteria along the lines of those suggested by the Treasury Department as a means to solve the definitional problem of independent contractor and minimize the opportunity for abuse. If such criteria were not met, we recommended that the individual be classified as an employee for tax purposes.

We still believe that the preferred course of action to assure tax compliance and protect workers is to provide for graduated withholding for independent contractors and adopt clear-cut classification criteria, such as those suggested by the Treasury 3 years ago.

If the subcommittee does not choose to follow that course of action, at the least we recommend that favorable consideration be given to the concepts embraced in H.R. 5867, introduced last March by Representative Frank Guarini.

That proposal is identical to the one reported by this subcommittee in the last Congress. It contains "safe harbor" rules intended to strike a delicate balance in the midst of controversy over classification standards.

We feel that the criteria set forth in H.R. 5867 represent less complex criteria than other pending proposals and should result in less litigation by those affected by its provisions.

It is the only proposal that also provides for a flat 10-percent rate of withholding on independent contractors with some built-in exceptions. While we would seek to improve H.R. 5867 along the lines of our earlier testimony, we urge that this subcommittee adopt its provisions as the proper starting point for deliberation.

Mr. Chairman, we appreciated your support in the last Congress when as a member of this subcommittee you helped develop the version of the bill that was reported after 5 months of extensive review.

With regard to the classification of workers as employees or independent contractors for Federal employment tax purposes, the comments of former subcommittee Chairman Rostenkowski are as pertinent now as they were in 1979, and I quote:

"In adopting its safe harbor concept to provide companies and workers with greater certainty in the determination of workers' classifications for tax purposes, the subcommittee worked at great length to develop straightforward rules.

"In this part of the bill the subcommittee has struck a sound delicate balance. Our safe harbor rules provide necessary clarity without being unduly broad. Not every employment relationship can be covered by this safe harbor or any meaningful rule. However, this section of the bill, as drafted, is supported by most groups interested in this legislation. In addition, it is viewed by the Treasury as a significant improvement over the approaches initially considered by the subcommittee. I hope that the full committee in reviewing this section will remain sensitive to the delicate balance achieved by the subcommittee."

I was quoting from the transmittal letter to the full committee dated December 13, 1979.

H.R. 5867 reaffirms the final product of this subcommittee's efforts in this complex subject area in the last Congress. We are opposed to H.R. 6311 and other proposals before this subcommittee because they could result in workers who have previously been classified as employees or whose status has been in dispute to be reclassified as independent contractors. This would come through the manipulation by payors who restructure the form rather than the substance of the work relationship to meet the requirements of such proposals.

Additionally, we feel the complexity of the criteria set forth in those proposals could result in substantial litigation. Also, each of those proposals fails to include the withholding requirements contained in H.R. 5867.

Finally, we recommend that any safe harbor test should by its terms be inapplicable to workers who are actually being treated by the employer as employees, for example, under the National Labor Relations Act or under the unemployment compensation law of the area in which the services are performed. Such provisions would aid in preventing retroactive switching from the classification of employee to that of independent contractor.

In sum, we urge the subcommittee to adopt classification standards that will prevent employers from manipulating and structuring the form rather than the substance of the work relationship to meet the requirements of safe harbor provisions.

Additionally, we urge that withholding on independent contractors to secure tax compliance be included in the final version of the bill. We believe that H.R. 5867 represents a positive step in the right direction.

Chairman STARK. Thank you, Mr. Koplan.

[The prepared statement follows:]

STATEMENT OF STEPHEN KOPLAN, LEGISLATIVE REPRESENTATIVE, DEPARTMENT OF LEGISLATION, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

The AFL-CIO appreciates this opportunity to present its views on efforts to develop legislation which would assure that employers and independent contractors pay their fair share of taxes.

We urge this subcommittee to narrowly limit the use of independent contractor status so that employers will be discouraged from circumventing their responsibilities and contributing to the exploitation of workers.

Apart from the tax equity issue, the AFL-CIO is concerned that the final version of the bill could serve as a means for unscrupulous employers to manipulate the form of employees' work relationships so as to benefit by having those employees classified as independent contractors.

Unless such machinations are prevented, employees will find themselves reclassified and excluded from job protections they now enjoy. For example, if reclassified as independent contractors, employees lose their eligibility for benefits under the unemployment compensation program (FUTA). These workers are also required to pay social security taxes at the higher self-employed rates; they do not have withholding for income tax purposes, and they lose opportunities for collective bargaining.

Whether a worker is classified as an employee or as an independent contractor could affect how that worker is treated under other laws. For example, many State income tax laws parallel Federal tax law and State income tax withholding generally coincides with Federal withholding rules. State unemployment compensation benefits depend upon whether workers were treated as employees and whether Federal Unemployment Tax Act (FUTA) taxes were paid on their wages.

Also, the Federal minimum wage applies to a worker classified as an employee. State minimum wage laws are similar. In addition, the reclassification of workers in firms in which some were treated previously as employees and others as independent contractors could alter the proper determination of bargaining units under labor relations laws.

Equally important, laws safeguarding work places, establishing standards for working conditions, providing workers' compensation, and affording protection from discrimination in hiring, promotion and benefits apply to workers only if they are classified as employees and not if they are classified as independent contractors. Even though a federal employment tax status reclassification is not binding for purposes of other laws, it could be a signal to administrators that the application of other laws is at issue. In sum, American workers and their families have a vital interest in the final outcome of these hearings that far transcends tax considerations.

The enormity of noncompliance in this area is shocking. In the last Congress, Treasury Department testimony before this subcommittee disclosed that at least 47 percent of workers classified as independent contractors did not report any of the compensation paid to them. At that time, the annual revenue loss from such noncompliance was conservatively estimated by the Treasury at $1 billion, about two-thirds of which is income taxes and about one-third of which is payments for the social security fund.

In order to capture the lost revenue, promote tax equity, and resolve the classification problem, we urge that the existing system for withholding on employees at graduated rates be expanded to independent contractors and clear-cut classification criteria be developed. Specifically, the common law test should be replaced with one that will narrow the category of those workers who now marginally fall into the status of an independent contractor. At present, there are 20 common law factors used to determine whether an employer-employee relationship exists. This leaves the door open to inconsistent interpretation of the common law rules governing employment status.

In 1979, the AFL-CIO endorsed criteria along the lines of those suggested by the Treasury Department as a means to solve the definitional problem of independent contractor and minimize the opportunity for abuse. The suggested criteria were as follows. If a worker had:

* a substantial investment in assets (other than transportation vehicles used in a non-transportation business);
* employees of his or her own who provided a substantial portion of the services for which compensation is received;
* substantial, continuing expenses and concurrently performed services for more than one payor;
* a separate place of business (other than a home office).

If such criteria were not met, we recommended that the individual be classified as an employee for tax purposes.

We still believe that the preferred course of action to assure tax compliance and protect workers is to provide for graduated withholding for independent contractors and adopt clear-cut classification criteria such as those suggested by the Treasury three years ago.

If the subcommittee does not choose to follow that course of action, at the least we recommend that favorable consideration be given to the concepts embraced in H.R. 5867 introduced last March by Representative Frank Guarini. That proposal is identical to the one reported by this subcommittee in the last Congress. It contains "safe-harbor" rules intended to strike a delicate balance in the midst of controversy over classification standards. We feel that the criteria set forth in H.R. 5867 represent less complex criteria than other pending proposals and should result in less litigation by those affected by its provisions. The proposal also provides for a flat 10 percent rate of withholding on independent contractors with some built-in exceptions. At the time of the 1979 hearings, the Treasury Department witness made the following observation regarding flat rate witholding. "Since the information necessary to implement a system for flat rate withholding on payments to independent contractors must be obtained by payors to comply with the information reporting requirements of present law (the worker's name, address and social security number), the additional costs associated with flat rate witholding should not be significant, in fact, the payor's use of the withheld tax pending payment of these amounts to the government should offset most, if not all, of these costs." While we would seek to improve H.R. 5867 along the lines that we suggested

BEST COPY AVAILABLE

earlier in our testimony, we urge that this subcommittee adopt its provisions as the proper starting point for deliberation.

Mr. Chairman, we appreciated your support in the last Congress when as a member of this subcommittee you helped develop the version of the bill that was reported after five months of extensive review. With regard to the classification of workers as employees or independent contractors for Federal employment tax purposes, the comments of former subcommittee Chairman Rostenkowski are as pertinent now as they were in 1979.

"In adopting its 'safe-harbor' concept to provide companies and workers with greater certainty in the determination of workers' classifications for tax purposes, the subcommittee worked at great length to develop straightforward rules. In this part of the bill, the subcommittee has struck a sound delicate balance. Our safe-harbor rules provide necessary clarity without being unduly broad. Not every employment relationship can be covered by this safe-harbor or any meaningful rule. However, this section of the bill, as drafted, is supported by most groups interested in this legislation. In addition, it is viewed by the Treasury as a significant improvement over the approaches initially considered by the subcommittee. I hope that the full committee in reviewing this section will remain sensitive to the delicate balance achieved by the subcommittee." (transmittal letter dated December 13, 1979)

H.R. 5867 reaffirms the final product of this subcommittee's efforts in this complex subject area in the last Congress. It retains the concept of withholding as the most effective way to combat compliance problems with Federal income and social security taxes by independent contractors. To quote past Treasury Department testimony, "information reporting can never replace withholding as a means of achieving satisfactory compliance."

We are opposed to H.R. 6311 and other proposals before this subcommittee because they could result in workers who have previously been classified as employees, or whose status has been in dispute, to be reclassified as independent contractors. This would come through the manipulation by payors who restructure the form rather than the substance of the work relationship to meet the requirements of such proposals. Additionally, we feel the complexity of the criteria set forth in those proposals could result in substantial litigation. Also, each of those proposals fails to include the withholding requirements contained in H.R. 5867.

Finally, we recommend that any "safe harbor" test should by its terms be inapplicable to workers who are actually being treated by the employer as employees under the National Labor Relations Act or under the unemployment compensation law of the area in which the services are performed. Such provisions would aid in preventing retroactive switching from the classification of employee to that of independent contractor.

In sum, we urge the subcommittee to adopt classification standards that will prevent employers from manipulating and structuring the form rather than the substance of the work relationship to meet the requirements of safe harbor provisions. Additionally, we urge that withholding on independent contractors to secure tax compliance be included in the final version of the bill. We believe that H.R. 5867 represents a positive step in the right direction.

Chairman **Stark**. Mr. Nolan?

STATEMENT OF JOHN S. NOLAN, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. **Nolan**. Mr. Chairman, my name is John S. Nolan. I am chairman of the section of taxation, American Bar Association, and will present the section's position as to the employee-independent contractor matter. The section supports the creation of safe harbor rules, new information reporting requirements, increased penalties, withholding in certain limited circumstances, a new statute of limitations provision, and Tax Court jurisdiction in employment tax cases.

The chaotic situation existing before the moratorium was imposed must not be allowed to recur. The moratorium should not be extended, however. A permanent solution must be adopted.

We favor the adoption of safe harbor rules which would assure certain persons of independent contractor treatment. We favor rules in the form contained in S. 2369, the most recent bill on this subject, whereby the person in question would be treated as an independent contractor, and not as an employee, if the following five tests are met: One, he controls the hours and scheduling of his work; two, he provides the place of business he uses, or pays a fair rent for any such facility; three, he either has a substantial investment in fixed assets or has fluctuating income dependent on sales or other output, rather than hours worked; four, there is a written contract that he will not be treated as an employee and he has written notice of his self-employment tax and income tax responsibilities; and five, the service-recipient for whom he provides the services files required information returns.

We oppose the somewhat narrower form of safe harbor rules proposed by the Treasury Department, and we oppose any broader form of safe harbor provision.

We endorse the antiswitching proposal of the Treasury. It would prevent employers who in the past have treated persons as employees from treating them as independent contractors under any such new safe harbor rules.

We would require the Internal Revenue Service to offset any employment tax assessments by self-employment taxes paid individually by the service providers. The Service is much better able to determine whether such taxes were paid. An alternative would be to make the result depend upon whether the taxpayer had a reasonable basis for treating a worker as an independent contractor and had complied with all reporting requirements. If so, the employer's liability could be limited to a portion of the FICA and FUTA tax, plus a low, flat percentage of the income taxes that would have been withheld.

We also favor stronger information reporting requirements, including reporting with respect to door-to-door salesmen and similar independent contractors.

Thus, existing law should be amended to require that in the case of information reporting in general, payees must furnish their name, address and identification number. Payors should be required to include that identification number on any return required to be filed to which the identification number relates.

Information reporting should be required with respect to sales of consumer products as provided in S. 2369. These direct sale provisions in S. 2369 would apply to every person engaged in a trade or business who, in the course of that business, sells consumer products to buyers for resale in the home on a buy-sell basis, a deposit-commission basis, or any similar basis when the aggregate sales to any one buyer during a calendar year are $5,000 or more. Any such direct seller would be required to file a return setting forth the aggregate amount of sales and the name, address and identification number of the buyer to whom the sales are made.

We recommend three changes in S. 2369: One, the provisions should apply to all buyers who resell outside of retail establishments, not merely those reselling in the home; two, the threshold for reporting should be sales of $1,000 or more to any buyer in any calendar year, not $5,000; and three, the provisions should apply only with respect to persons who regularly sell their products to persons who resell in the home or outside of retail establishments.

Mr. Chairman, I see my time is up. I will just say that we do recommend a somewhat different penalty structure than the bills that have been proposed.

We propose a two-tier penalty structure whereby the first time a person is in violation, he has a small penalty, and then if there is a second violation, a much larger penalty applies. That will prevent undue burdens on people who inadvertently violate these rules.

We would also support withholding in situations where a person fails to file, or files an incorrect identification number. We propose that a statute of limitation of 6 years be imposed on these liabilities, and we support Tax Court jurisdiction in employment tax cases to avoid many of the problems that arise today in litigating these cases.

Thank you.

[The prepared statement follows:]

STATEMENT OF JOHN S. NOLAN, CHAIRMAN, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

EMPLOYEE/INDEPENDENT CONTRACTOR MATTER

My name is John S. Nolan. I presently serve as Chairman of the Section of Taxation, American Bar Association, an organization of 25,000 tax lawyers throughout the United States. I am here to present the position of the Section of Taxation on bills to create a safe harbor for independent contractors, enact new information reporting provisions, increase the penalties for failure to file such statements, and require withholding in certain limited situations. In general, the Section of Taxation supports such bills. We urge their enactment with certain modifications relating primarily to penalties and expansion of Tax Court jurisdiction.

Safe Harbor for Independent Contractors

As this Committee is aware, the moratorium on Internal Revenue Service action in the employee/independent contractor area will expire on June 30, 1982. This moratorium was originally imposed by Congress because prior thereto, the Internal Revenue Service often took an unduly aggressive position in contending that workers being treated as independent contractors were instead employees for tax purposes. This occurred even in cases where an entire industry treated such class of payees as independent contractors.

Typically, the Service would assess withholding, Social Security, and unemployment taxes for a three-year period. The payor then had the burden of proving that the workers had paid self-employment and income taxes. This burden was extremely difficult to carry because of the length of the period usually covered and the transient status of many of the workers. A further problem was the time consumed in contesting the assessment, with the tax periods between the assessment and the end of litigation being either held open or resulting in new assessments, generating additional liabilities. If the taxpayer won, the Service often reasserted its position against other taxpayers. In some instances, the Service lost as to a particular type of worker in several United States Courts of Appeals, only to relitigate the issue in another Circuit.

We think it is essential that the chaotic situation occurring prior to the moratorium should not recur. An extension of the moratorium is not the best means of accomplishing this result. The moratorium was intended to be a temporary measure which, in the words of Senate Report 95-1263, would "provide interim relief *** until the Congress has adequate time to resolve the many complex issues involved ***." Although this provision has been previously extended, a further extension would only delay a permanent solution and have the negative effect of leaving the law unresolved.

The enactment of safe harbor provisions will provide greater certainty in this complex area and, as a result, will remove many of the inequities of the law as it was applied prior to the enactment of the moratorium. Taxpayers will be able to meet the tests provided by the safe harbor provisions and know that they would not be subject to employment tax assessments. Since the payor will be required to file information returns, tax revenues presumably will be increased. The bill would also retain the common law tests in instances in which the safe harbor rules do not apply.

The most recent bill on this general subject is S. 2369, introduced by Senator Dole, and the following comments will focus upon the specific provisions of that bill. S. 2369 treats an individual performing services as not being an employee when the following requirements are met: (1) the worker controls the aggregate number and substantially all of the scheduling of hours worked; (2) no principal place of business is provided by the service-recipient unless the worker pays a fair rental; (3) the worker either has a substantial investment in assets of significant value in performing the services or risks income fluctuation because more than ninety percent of the remuneration is directly related to sales or other output rather than the number of hours worked; (4) the worker performs the service pursuant to a written contract stating he will not be treated as an employee for purposes of employment taxes or employee benefits and is given written notice concerning his responsibility for paying self-employment and income taxes; and (5) the service-recipient files the required information returns.

This safe harbor in S. 2369 is necessarily a compromise. There are many individuals who may be independent contractors in the common law sense but who will be unable to meet these requirements. Expansion of the safe harbor, however, would allow many who are employees to avoid employee treatment, and we oppose such expansion.

The Treasury has proposed a much narrower safe harbor. In lieu of the first three requirements of S. 2369, the Treasury's safe harbor would require that the worker be paid on a basis other than an hourly or salary basis. In addition, the worker would be required to meet one of three conditions to avoid employee status: (1) maintenance of a principal place of business which, if contained in the worker's home, meets the requirements of §280A of the Internal Revenue Code; (2) ownership of substantial assets used in connection with the performance of the services; or (3) incurring of substantial unreimbursed expenses of a particular type, such as payroll expenses, supplies, or cost of goods sold, in performing the services.

We do not agree with this Treasury proposal. Many individuals who have a substantial investment in assets but who do not have fluctuating income should be within the independent contractor safe harbor. S. 2369 sets forth the required "income fluctuation" or "investment in assets" tests as alternative requirements, rather than dual requirements, thus enabling such persons to be treated as independent contractors.

We endorse the Treasury proposal for an "anti-switching" provision which would prevent employers, who in prior periods have treated their workers as employees, from treating those workers as independent contractors under these safe harbor provisions. The anti-switching provision would accord with the requirement of §530 of the Revenue Act of 1978 that, in order for a service-recipient to be covered by the moratorium, he must not have treated workers as employees prior to 1980.

Another change which we recommend is to require the Service, when it assesses employment taxes, to offset the assessment by the amount of self-employment taxes paid individually by the workers. Under the current system, the taxpayer has the burden of proving that such taxes were paid. The taxpayer is often unable to do so because of the length of the assessment period and the lack of current information concerning the workers. The Service is much better able to determine whether such taxes were paid and should be required to do so. A possible alternative, mentioned in the Treasury Department's statement, would be to make the result depend upon whether the taxpayer had a reasonable basis for treating a worker as an independent contractor and had complied with all reporting requirements. If these tests were satisfied, the employer's liability would be limited to a portion of the F.I.C.A. and F.U.T.A. tax, plus a low flat percentage of the income taxes that would have been withheld. This should be studied further.

Increased Penalty for Failure to File Information Returns

Present law requires that all persons engaged in a trade or business, who make a payment in the course of that business of "compensations, remunerations, *** or other fixed or determinable gains, profits, and income *** of $600 or more", report such payment to the Internal Revenue Service. The payor must also furnish a copy to the payee receiving such amount. Income is "determinable" for this purpose when there is a basis of calculation by which the amount to be paid can be ascertained. Thus, most payments of income are covered by the provision. The penalty for failure to file or failure to furnish each such statement is $10.

If the statements so required were actually filed and furnished to workers in all instances, tax compliance would be greatly increased. The workers would then know that the Internal Revenue Service has the information needed to enforce the law against those who fail to file, or who file false returns. By limiting application of these information reporting requirements to payments in the course of a trade or business, no undue burden is imposed on service recipients. The difficulty with the existing information reporting requirements is not what the law says, but in the failure of taxpayers to comply with it. In our judgment, compliance would be substantially improved if penalties are increased, although we propose penalties somewhat different from those proposed in S. 2369.

A further problem is that existing law fails to require reporting from persons selling merchandise to door-to-door salesmen and similar independent contractors. Such latter group of salesmen may be described as sales representatives who are compensated through their retention of deposits, or the difference between the prices at which they purchase products and those at which they sell them. The Service has no means of identifying such sales representatives and insuring that they report their sales income. Information reporting by persons who sell to such sales representatives is necessary.

S. 2369 would require that in the case of information reporting in general, payees would be obligated to furnish their name, address, and identification number. Payors would be required to include that identification number on any return required to be filed to which the identification number relates. Also, S. 2369 would require information statements to be filed with respect to sales of consumer products. These "direct sale" provisions apply to every person engaged in a trade or business who, in the course of that business, sells consumer products to buyers for resale in the home on a buy-sell basis, a deposit-commission basis, or any similar basis when the aggregate sales to any one buyer during a calendar year are $5,000 or more. A transaction is on a "buy-sell basis" if the buyer performing the services is entitled to keep the difference between the price at which the product is purchased and the price at which it is sold as all or part of his remuneration. The transaction is on a deposit-commission basis if the buyer performing the services is entitled to retain the deposit paid by the consumer as all or part of his remuneration. If the direct sale provisions apply, the person must file a return setting forth the aggregate amount of sales and the name, address, and identification number of the buyer to whom the sales are made.

A direct seller could elect to have alternative reporting requirements apply in any calendar year. These apply the usual reporting rules for payments for services as if the minimum were $50 rather than $600. In addition, the seller would be required to file a return listing the name and identification number of each buyer to whom he had aggregate sales of $50 or more during the calendar year. He would be required also to furnish each person listed a statement showing the name, address, and identification number of the person making the return. The returns and statements, however, would not be required to include the amount of sales to each buyer.

S. 2369 would enact complex penalty provisions for failure to file information returns relating to payments for services, failure to furnish statements required, or failure to include the entire amount required to be included on such a return or statements. The penalty is generally 1% per month for each month during which the failure continues, up to a maximum of 5%, multiplied by the amount required to be included on the return or statement, subject to a minimum penalty of $50. The penalty would be increased when the ratio of the total failures to file, furnish, and include the requisite amount, in relation to the total number of returns and statements required to be filed or furnished, exceeds 10%. If that "noncompliance percentage" is between 10% and 20%, the penalty is doubled, and if it is over 20%, the penalty is tripled. Because the failure to file and the failure to furnish give rise to separate penalties, a person who failed to file or furnish over 20% of the required returns and statements for more than four months after the due date would be assessed with a maximum penalty of 30% of the amounts not reported.

The penalty for each failure to file a direct sales return listing calendar year sales to qualified buyers aggregating $5,000 or more, to furnish a direct sales statement, or to include the correct amount on such a return or statement would be one-fifth of one percent of the amount not reported or furnished for each month the failure continues, up to a maximum of one percent. This penalty is not increased when the noncompliance percentage exceeds ten percent. If the direct seller elects the alternate reporting provisions, however, and thus is required to file when payments for services exceed $50 in any calendar year, the penalties regarding returns and statements for services would apply, including the increase for a noncompliance percentage in excess of ten percent.

We agree that there should be information reporting concerning buyers who resell consumer products in the home, as generally provided in S. 2369, but we recommend three changes. First, S. 2369 should cover all buyers who resell outside retail establishments rather than only those reselling in the home. The compliance problem extends to the larger group. Second, we believe the threshhold for reporting should be $1,000 rather than $5,000. A $1,000 threshhold would extend the benefits of such reports to a larger group while insuring that only those who have earned a significant amount of income will be covered. The Treasury proposal of a $100 threshhold is far too low, however.

Finally, the provisions of S. 2369 could apply to any seller who, in the course of his trade or business, makes one sale to a buyer who will resell the product in the home to receive his remuneration in the prescribed way. Any seller of consumer products could be subject to these provisions. Yet, many of these sellers would not know when their products would be resold in the prescribed manner. For instance, a candy manufacturer may sell its products to numerous sole proprietors for sale in the stores. The manufacturer may not know that one of its buyers intends to resell the product in a home. The only way the candy manufacturer could protect against penalties would be by electing the alternative provision and reporting on all buyers, including major department stores and other established retailers. This result does not appear to be intended. Senator Dole referred in the statement accompanying S. 2369 to reports concerning the direct sellers' "sales representatives" and their "actual sales force". April 14, 1982, Congressional Record S. 3509. Hence, the concern would seem to be with sellers who regularly sell their products through buyers who resell in the home. We respectfully submit that these provisions should be limited to such sellers.

We also disagree with the penalty provisions of S. 2369. We believe that a two-tier penalty is a better and simpler means of dealing with a failure to file returns or furnish statements regarding independent contractors. We recommend a $50 penalty for the initial failure to file the form or furnish the statement. If any failure to file or furnish occurs after the assessment of a previous penalty, a second-tier penalty of 15% of the amount required to be reported should be imposed. Because the filing of the return and the furnishing of a statement are separate duties, a maximum 30% penalty should be imposed if the payor fails both to file and to furnish. Hence, while we agree with the amount of the S. 2369 penalty, we disagree as to when it should be imposed. For example, S. 2369 would impose the maximum 30% penalty against a taxpayer who is simply unaware of the requirement to file and furnish information returns and statements; ignorance would not constitute reasonable cause. We respectfully submit that a lesser penalty should be applied the first time, and that only thereafter are substantial penalties justified. In addition, the provisions of S. 2369 are unduly complex and, for that reason, may fail to encourage compliance.

Withholding on Independent Contractors

S. 2369 requires withholding in certain limited situations. If a payee fails to provide the required identification number, the payor must deduct and withhold 15% of the amount paid during any period for which the required identification number has not been provided. The payor may also withhold during the seven-day period following that period. If the payee has provided an incorrect identification number, the Service must notify the payee that he has sixty days to correct that number. If the payee fails to do so, the Service would notify the payor of this fact. The payor would then be required to withhold 15% of any payment to the payee from the eighth day after such Service notification until the eighth day after further Service notification to the payor that the number had been corrected. No amount need be deducted and withheld unless the total of the payment and all previous payments during the period covered by the return exceeds the $600 minimum (or $50 minimum under the direct seller elective provision) which must be paid before the return is required to be filed. Payments to the United States, any agency or instrumentality thereof, any state or political subsidivision thereof, exempt organizations, foreign governments, and international organizations are not subject to withholding. The bill requires the Service to prescribe regulations for exemptions from withholding during periods when a payee is waiting for a required identification number.

We recognize the the Service currently has little recourse when a payee refuses to supply an identification number or gives an incorrect number. The Service has not obtained correct information, and accordingly the Service cannot insure payment of the required taxes by the worker. A payee can avoid further withholding under S. 2369 simply by supplying the required identification number. Thus, the burden on innocent payees should be small, but the bill will tend to force those who intentionally do not supply identification numbers, or who give incorrect numbers, to give correct and complete information to the Service. We agree that withholding is justified in these circumstances.

Exception to Statute of Limitations

S. 2369 would add a new statute of limitations provision. The proposed new provision would require that penalties for failures to file or furnish information returns or statements be assessed, or court proceedings be begun, within six years after the last date for filing, unless the return or statement is fraudulent, there has been a willful attempt to evade, or the limitation has been extended by agreement. Hence, this section establishes a statute of limitations in instances in which no return or statement has been filed or furnished. We agree that there should be such a limitation on the Service's ability to assess or collect.

Expansion of Jurisdiction of Tax Court

The Tax Court currently does not have jurisdiction over controversies involving employment taxes. The only means of contesting such taxes is to sue for a refund in a district court or the Court of Claims. Although ordinarily the entire liability must be paid prior to litigating a refund case, the courts have, in effect, modified this requirement in employment tax cases by characterizing employment taxes as divisible. Thus, a court will have jurisdiction if the taxpayer pays the taxes applicable to one individual in each of the periods involved.

The Tax Court's lack of jurisdiction often causes delay in litigating cases involving employment taxes. If the Tax Court had jurisdiction, a notice of deficiency would be sent to the taxpayer and the taxpayer would then have ninety days in which to file a petition with the Tax Court. Under current tax litigation procedures, an employment tax is assessed and the taxpayer must pay a portion and file a claim for refund. He then cannot file suit until the earlier of the disallowance of his claim for refund by the Service or the expiration of six months. Thus, many taxpayers are required to wait at least six months before they can file suit. In the meantime, additional potential liabilities have accrued.

Because the tax has already been assessed, the Service has the power to collect the tax at any time, even if a claim for refund and a complaint have been filed. The Service has stated that it does not collect the taxes in this situation unless there is jeopardy, but there have been instances in which the Service has attempted to collect such taxes in the absence of jeopardy. Moreover, the Service has never given instructions to its agents prohibiting them from collecting such taxes in the absence of jeopardy. Thus, taxpayers against whom employment taxes have been assessed remain subject to the risk that an action will be brought against them to collect the entire amount of taxes in issue before they can obtain a court determination as to the validity of those taxes. This is a risk to which they would not be subject if they had recourse to the Tax Court.

We believe that taxpayers against whom employment taxes are assessed should be able to litigate the issue in the Tax Court before the tax is required to be paid. Accordingly, we recommend that the Tax Court's jurisdiction be expanded to include controversies involving such taxes.

[Attachment to the prepared statement follows.]

SUGGESTED TECHNICAL CHANGES

TO

H.R. 6055; THE SUBCHAPTER S REVISION ACT OF 1982

BY

THE SECTION OF TAXATION OF THE AMERICAN BAR ASSOCIATION

The following comments are being submitted by the Section of Taxation of the American Bar Association as a supplement to the written testimony to the Subcommittee on Select Revenue Measures of the House Ways and Means Committee on June 14, 1982. Each of the proposed new sections 1361 through 1379 are discussed section by section. It should be noted that the discussion does not take into consideration the amendments proffered by the Subcommittee on Select Revenue Measures inasmuch as the Section of Taxation of the American Bar Association has not fully reviewed those amendments.

SEC. 1361. S CORPORATION DEFINED.

Summary.

Proposed section 1361 corresponds essentially to the Internal Revenue Code of 1954 ("Code"), section 1371 in defining a corporation's eligibility to make a Subchapter S election. An electing corporation is defined as an "S Corporation"; a non-electing corporation is defined as a "C Corporation." The term "small business corporation" has a similar definition to that contained in existing law, with these changes:

-- The permitted number of shareholders is increased from 25 to 35 (corresponding to a prevalent securities law test for private placements);

-- Differences in voting rights among the shares of common stock specifically do not violate the single class of stock requirement.

-- The new term "ineligible corporation" is introduced to describe several categories of corporations which would not be permitted to make a Subchapter S election, some of which are eligible for election under existing law.

Technical Comments.

Ineligible corporation defined.

Under existing law, if the requirements are otherwise met, a Subchapter S election is available to a domestic corporation which is not a member of an affiliated group for consolidated return purposes. This means that domestic banks, stock savings and loan associations, insurance companies, and possessions corporations are eligible to make a Subchapter S election. Moreover, an electing corporation may own 80% or more of any corporation which by the terms of code section 1504(b) is ineligible to join in a consolidated return. Permitted subsidiaries include insurance companies, foreign corporations, possessions corporations, DISCs and former DISCs. Proposed section 1361(b)(2) would deny S Corporation status to these categories of corporations, a significant change of approach. While existing law merely veers from the complexity of the consolidated return, the Bill veers also from corporations which have special items of deduction or credit.

The rationale for this change likely corresponds to the greater adherence in the Bill to the partnership model for the pass-through of items of deduction and credit. Such rationale appears valid in the case in which the S Corporation itself is in the special category; for example, one may question the pass-through of large additions to bad debt reserves or other special reserves. However, the rationale does not appear valid when applied to a subsidiary corporation which cannot join in a consolidated return. The subsidiary corporation could not pass-through specific items.

We understand that, for the most part, financial institutions and insurance companies have not been attracted to Subchapter S, perhaps because the limited number of permitted shareholders tends to restrict the capital base for such companies. Consequently, making those types of corporations themselves ineligible is not likely to cause hardship or raise opposition to the Bill. However, we understand that a significant number of electing corporations do have DISC or former DISC subsidiaries and foreign subsidiaries. Without grandfather rights or other transitional rules, these electing corporations would suffer immediate termination of S Corporation status. That prospect suggests potential hardship and opposition to the Bill, and we question whether sufficient policy grounds exist to require such results.

Certain Trusts Permitted as Shareholders.

Two technical corrections to proposed section 1361(c)(2)(A) should be considered:

- Clause (i), permitting grantor trusts and certain other trusts to be shareholders of an S Corporation refers to an "individual." In community property states, the transfer to such trust by a husband and wife of their community property interests in electing corporation stock should not terminate the Subchapter S election.
- Clause (ii) provides for a two year grace period in the case of such trust if the entire corpus is included in the estate of a deemed owner. The two year period should also apply in the case of such trust created by a husband and wife with community assets when one spouse dies, even though only the decedent spouse's share of the community property trust corpus is included in the decedent's gross estate.

A further point has been raised by the Internal Revenue Service in its proposed regulations under code section 1371(e) as published in the Federal Register on April 8, 1980. On the theory that the enactment of section 342 of the Revenue Act of 1978 constitutes an expression of congressional intent "to limit stock ownership in a small business corporation to direct and unqualified stock ownership, except for certain trusts meeting the statuatory requirements," the proposed regulations would provide that stock of an electing corporation may not be held as a split or partial interest such as a legal life estate, usufruct or remainder interest. We do not favor such new limits and suggest that the congressional intent be clarified in the legislative history pertaining to the Bill.

Differences in Common Stock Voting Rights Disregarded.

The matter of shifting or deferring income in a family context is adequately dealt with by the Bill:

- Proposed section 1366(e) provides authority to adjust items taken into account by family members, within the meaning of Code section 704(e), in order to reflect the value of capital or services;
- Code section 267 would be amended by adding a new subsection (f) to prevent deferral of income by reason of the accrual of unpaid expense, including interest

expense, payable to a 2% shareholder or any person related to a 2% shareholder.

The 2% threshold appears to be extremely low. We believe that the percentage should be tied to a logical basis, which should be articulated in the legislative history. For example, a 10% threshold is used in code section 401(c)(3) to define an owner employee in the fringe benefits area.

We welcome the rule permitting differences in voting rights among shares of common stock. Other differences among shares might also be acceptable as long as differences do not:

-- Create doubt as to the person responsible to report income or loss;

-- Create undue administrative burden;

-- Cause income to be shifted or deferred among related taxpayers;

-- Permit ineligible persons to become equity holders when there is improper tax avoidance.

Some of the above were suggested by the Treasury Department in its 1969 proposals. We urge that consideration be given to the adoption of rules permitting separate classes of stock as long as the as the above principles are followed.

Hybrid Instruments.

There has been extensive discussion concerning hybrid debt instruments which in today's money market are more prevalent than they once were. These instruments carry so-called "equity kickers"; that is, their yields may include percentages of earnings or they may be convertible into stock in some manner. We urge that any determination about such instruments not be used to jeopardize an S Corporation election, and specifically, the proposed regulations under Code section 385 should not be applied as a test of Subchapter S eligibility. However, we acknowledge that hybrid instruments should not be allowed in effect to admit ineligible shareholders if there is improper tax avoidance. We believe this problem can be solved by including language that, for purposes of determining Subchapter S eligibility, an instrument which is not stock under the issuing corporation's charter would not be classified as stock unless the issuance has an improper tax avoidance purpose or effect which can not be adequately solved without termination of the election. Such rule should relieve most small business owners of the potential trap of Subchapter S termination upon securing legitimate loans with reasonable terms currently required by lenders; at the same time, cases of obvious abuse could be addressed.

Nevertheless, we strongly urge that no instrument issued for cash be deemed to be stock for any Subchapter S purpose unless over one-half of its economic value is attributable to an equity feature that results in an income participating yield, and otherwise results in improper tax avoidance.

C to S Problem.

We recommend that debt instruments recharacterized as equity during a C period continue to be so treated during an S period, but not for purposes of determining S Corporation eligibility, unless they otherwise present tax avoidance problems.

Securities Law Restrictions.

We recommend that a Subchapter S election not be terminated as a result of restrictions imposed upon shares by action of a governmental agency. For example, under the rules of the California Department of Corporations, a person receiving shares for services may be deemed a promoter with the result that restrictions are placed upon his shares -- e.g., that the promoter waive dividend distributions until the corporation becomes profitable. As a practical matter, no dividends are paid to any shareholder until the restrictions are lifted. In Page v. United States, 580 F.2d 960 (9th Cir. 1978), such restrictions were held to create a second class of stock, and the corporation's subchapter S electon was invalidated. On the condition that each shareholder (including the promoter) reports a pro rata share of current income and is entitled to eventual distribution of it, the restrictions imposed by a governmental agency should not terminate the election.

Qualified Subchapter S Trust.

This section attempts to restate Code section 1371(g). However, at the end of proposed section 1361(d)(3)(B) after the word "or" the phrase "resident of the United States, and" was inadvertently omitted. It should be noted that the Technical Corrections Bill of 1982, H.R. 6056, introduced on April 1, 1982, would modify certain aspects of this subsection. These suggested changes should be incorporated here.

Sec. 1362. Election; Revocation; Termination.

Summary.

Proposed section 1362 closely follows Code section 1372 with the following changes:

-- The election period has been liberalized and specific rules have been included stating when the election takes effect.

-- The termination rules have been relaxed by eliminating the requirement that all new shareholders concur in the election by filing a consent, and the passive investment income restriction will be applied only to those S corporations having earnings and profits at year end.

Technical Comments.

Election.

It is unclear whether proposed section 1362(a) requires the consent of a former shareholder who disposed of his stock during the year or the first 2½ months of the following year, or merely those shareholders who own stock as of the election date. This confusion stems from reading the daily pro rata allocation rules of proposed section 1377 in conjunction with the election provision. Likewise, no mention is made whether an election to take effect in the future may be rescinded by either the corporation or the consenting shareholders prior to the stated effective date. These concerns should be clarified in reports accompanying the proposed Bill.

Termination.

When proposed sections 1362(d)(1)(A) and (B) are read together, it is unclear whether the corporation may revoke, the shareholder may revoke, or both must concur in the revocation before it is effective. It is desirable to allow the corporation upon the concurrence of a specified percentage of the shareholders to revoke the election.

Effective Date.

No mention is made whether a revocation to take effect in the future may be rescinded by persons making the election prior to the stated revocation effective date. This should be covered in the Bill or the accompanying reports.

Passive Interest Income.

General.

De Minimus Rule.

Proposed section 1362(d)(3)(B) retains the exception for a corporation having passive investment income of less than $3,000 during the first taxable year in which it commences the active conduct of a trade or business or during the next succeeding year. The exception would appear to have less application in the context of new law; its application would be confined to a situation in which a corporation has just commenced the active conduct of a trade or business, but nonetheless has some E&P. Accepting the premise that such cases justify retention of a de minimus rule, in today's economy we suggest raising the amount to, say, $10,000.

Effective date of termination.

Although proposed section 1362(d)(3)(A)(ii) retains the rule that a termination occasioned by excessive passive investment income would be effective as of the first day of the taxable year, language in Code section 1372(e)(5)(A) referring to succeeding taxable years is deleted. Such deletion appears to facilitate the operation of proposed section 1362(f) providing for relief from inadvertent termination.

Comments on the Proposed Retention of a Passive Investment Income Restriction and Recommendations.

Background.

Following publication of the Joint Committee on Taxation, 96th Cong. 2d. Session, Staff Recommendations for simplifications of tax rules relating to Subchapter S Corporations (Joint Committee Print April 30, 1980)(hereinafter Joint Committee Staff Recommendations), concern was expressed that repeal of Code section 1372(e)(5) would give rise to a proliferation of private investment corporations. Attention has focused on the circumstance in which an existing corporation with earnings and profits ("E&P") sells its operating assets, reinvests the sales proceeds in passive investments, makes a Subchapter S election, and follows a course of distributing investment income without reaching E&P. Most who have expressed concern about this circumstance identify the E&P account generated during a C period as the source of problem. As a tentative solution, the Bill retains the passive investment income restriction, but applicable only to corporations with E&P.

Suggested first step: delete all S period E&P.

Pursuant to proposed section 1371(C)(1), generally no increase is made to an S corporation's E&P account; S period operations do not produce E&P. Consistent with this approach, for purposes of determining whether a passive investment income test applies, we recommend that the E&P account be reduced by any amount generated during a period in which a Subchapter S election was in effect. This simply acknowledges that during any S period, whether before or after the effective date of the Act, the electing corporation's income was taxed at individual rates. Consequently, there is not raised here the concern on which the retention of a passive investment income restriction is based. That concern properly focuses only upon E&P generated during a C period.

Suggested second step: modify the restriction.

Whatever further solution may be adopted, if a passive investment income restriction is retained for any purpose, we believe it should be modified as described below.

(a) PHC Definition. Experience under existing law has shown that numerous active businesses are prevented from making a Subchapter S election because the definition contained in Code section 1372(e)(5) is keyed to the type of income produced rather than the nature of the business activity producing it. For example, no distinction is made between interest income derived from bond coupons, installment obligations, and interest income earned by an active loan company. The loan company cannot maintain a Subchapter S election. Moreover, many active real estate businesses are barred from keeping an election because of rental income. One approach would be to shift emphasis to the word "passive", and adopt standards such as those contained in the Treasury Regulations under Code section 355 to distinguish the active conduct of a trade or business. However, such an approach requires difficult and recurring factual issues and it may be preferable to retain an objective test. We recommend that the "personal holding company income" rules of code Section 543 be applied as the standard. These rules are well established, and are familiar to tax advisers and even to many small business owners. We recommend, however, that certain modifications be made as to permit certain types of rental and interest income that are clearly "active" income to certain corporations.

(b) Alternative. If a standard similar to existing Code Section 1372(e)(5) is retained, we believe it should be modified as follows:

-- Exclude interest income generated by a lending or finance company (other than an excluded corporation) as defined in Code section 542(c)(6) and (d), and by an SBIC as provided in Code section 542(c)(8);

-- Exclude interest income derived from installment obligations received from the sale of property to customers in the ordinary course of business; and

-- Exclude rental income.

-- Increase the threshold to 60% to accord with the threshold in Code Section 542(a)(1) or to 50% by analogy to Code Section 1244. Further, a new rule could provide that the Subchapter S election is terminated only if the threshhold is exceeded for 2 of any 3 taxable years, and that such termination shall be prospective rather than retroactive.

-- Include in gross receipts only the gain portion of the sale proceeds of commodities held for less than one year. Such a rule would restrict the ability to shelter passive investment income by short-swing commodities trades.

Further Solution.

We believe an approach by which an S Corporation with E&P would be provided an election not to be subject to a passive investment income restriction should be considered. If such election were exercised with the consent of all shareholders, a capital gain would be recognized by each shareholder, measured by the lower of (1) such shareholder's share of E&P or (2) the amount of gain that would be recognized by such shareholder if the corporation were liquidated under Code section 331. To respond to potential liquidity problems, the gain could be recognized over a period of time such as five years. To limit potential abuse, if the Subchapter S election is terminated within the specified period, gain would be recharacterized as ordinary income to the extent of any distributions of E&P. Similar recharacterization would occur if the corporation liquidated pursuant to Code section 333.

We feel that the elective toll charge is an especially promising alternative.

Inadvertent Terminations.

It is unclear whether proposed section 1362(f)(3) is applicable to each termination event identified in proposed section 1362(f)(1). For example, termination occurs under proposed section 1362(d)(2) because the corporation ceases to be a small business corporation; proposed section 1362(d)(3) because of excessive passive income; and proposed section 1362(d)(4) because of the receipt of foreign income. To avoid any question as to the applicable scope of proposed section 1362(f)(3), the words "so that the corporation is once more a small business corporation" should be deleted and the words "to eliminate the event causing termination" should be substituted.

Foreign Source Income.

Proposed section 1362(d)(4) retains the restriction on foreign source income. We are not aware why. We believe the restriction should be repealed.

SEC. 1363. EFFECT OF ELECTION ON CORPORATION

Summary.

This proposed section adds totally new concepts. It combines certain parts of Code section 1372(b) and 1373(d).

- -- The tax effect of the election on the corporation is redefined.
- -- The elections permitted in other Code sections are divided between the corporation and shareholder.
- -- A new rule is adopted regarding distributions of appreciated property.

Technical Comments.

Elections.

We do not understand why proposed section 1363(c)(2) contains no reference to Code section 57(c). We feel this should be added to conform the election under this proposed section with Code section 703(a)(2).

Taxable Income.

Proposed section 1363(b) should be coordinated with proposed section 1374(d), and one or the other eliminated. We perceive no reason for two distinct definitions for taxable income of an S corporation.

Appreciated Property Distributions.

General.

While we welcome the addition of this proposed subsection for corporations having accumulated E&P, we believe it does not go far enough. This proposed section should cover losses on the distribution of property as well as gains.

We strongly urge that this proposed subsection be limited to S corporations having accumulated E&P. As with partnerships, non-terminating distributions of long-term capital gain appreciated property should not give rise to tax at any level when there has been no buildup of value through accumulated E&P. Then, as with partnerships, carryover basis rules should be employed at the shareholder level for such distributions. Other types of S corporation distributions for non-accumulated E&P should also follow partnership rules.

Further, it is not clear what the reference to coordination with Code section 311 is designed to accomplish. We suggest proposed section 1363(d)(2) be clarified in this regard.

Recapture and Other Rules.

No apparent consideration has been given to coordinating the tax imposed under proposed section 1363(d) with the recapture tax provision of Code sections 49, 1245 and 1250. Under no circumstances do we believe a double tax is justified on a distribution of appreciated property.

If it is contemplated that the Subchapter C liquidation provisions override the Subchapter S provision there must likewise be some coordination with Code section 1239 to avoid double taxation.

Code Section 331.

It is not clear whether a distribution under Code section 331 is excluded from proposed section 1363(d)(3). This should be clarified.

Section 1366. Pass-Through of Items to Shareholders.

Summary.

This proposed section modifies current law in that the character of the items of income, deduction, loss and credit are passed through to shareholders in the same general manner as they pass through in partnerships. Excluded are certain capital gains adjustments and allowable credits under Code Section 39. It also adds new rules to permit the Treasury Department to make adjustments when services are rendered or capital is provided by family members to prevent undesirable income splitting.

Technical Comments.

General.

To avoid the unnecessary confusion on the part of small businessmen, we suggest the following changes:

-- Add the words "as defined in Section 1377" after "shareholders prorata share", in proposed Section 1366(a)(1).

-- Add the words "by the shareholder" after the words "such items were realized", and after the words "or incurred in proposed Section 1366(b)."

-- Add the words "as defined in Section 1377" at the end of the last sentence in proposed Section 1366(d)(3)(A).

Other.

It is unclear to us why reference to debt is omitted in proposed Section 1366(d)(3)(B). We preceive no policy reason for this omission. In addition, the reference to debt makes this proposed subsection consistent with proposed Section 1366(d)(1).

We do not understand the reason for excluding the credit allowed under Code Section 39 in proposed Section 1366(f)(1) while on the other hand permitting the credit in proposed Section 1374(b). Such technical nicities merely confuse the small businessman.

Section 1367. Adjustments to Basis of Stock of Shareholders, Etc.

Summary.

The proposed section 1367 basis adjustment rules closely follow the partnership basis rules set forth in Code Section 705 except for income items which are not included in the gross income of an S corporation shareholder, and are not shown on his return.

Technical Comments.

If the desire is to provide for the greatest likeness possible, and also avoid confusion between the S corporation and a partnership it seems that non-taxable items of income such as tax-exempt interest should be as available to a stockholder as to a partner. To carry out this purpose the provisions of paragraph (1) of Section 1367(b) should be expanded to include as income all items of income as defined by subparagraph (A) of Section 1366(a)(1) without any requirement of the inclusion of the items in the gross income shown on the shareholder's return.

By comparison, if an S Corporation realizes tax-exempt interest income, the distribution can result in the shareholder being required to report capital gain income after his basis has been recovered whereas in a partnership such income can be earned at the partnership level and distributed to the partner without any such possible income realization. It appears that this restrictive provision is present only to prevent an S Cororation from investing its funds in tax-exempt obligations and avoiding the distribution of its accumulated earnings and profits. A solution to this possibility is to provide in Section 1368(c) a new subparagraph (1) which states that

> "That portion of the distribution which does not exceed the undistributed accumulated gross income realized by the S Corporation on any tax-exempt obligations shall be treated as a dividend to the extent it does not exceed the accumulated earnings and profits of the S Corporation."

It will then be necessary to renumber the remaining subparagraphs to "(2)" and "(3)" in lieu of (1) and (2).

By adopting this order of distribution, a shareholder would still have a part of the future basis of his stock available to be recovered through distributions (like a partnership) without realization of a capital gain (the same as a partner would) but, at the same time, S Corporation status would not be elected just to realize passive tax-exempt income without being required to distribute its accumulated E&P. This additional provision does not create a tax-trap for the S Corporation without E&P and provides similar treatment for tax-exempt income as would be realized by a partner, and will prevent a tax loophole in this Bill.

If the above concept is adopted, subparagraph (1) of proposed section 1367(b) should be deleted and the subsquent two subparagraphs renumbered.

We perceive no reason why the coordination provision of proposed section 1367(b)(3) should be limited to stock. We believe this subsection should be expanded to include debt described in Code Section 166.

Section 1368. Distributions.

Summary.

This proposed section contains entirely new rules which describe separately the effect of a distribution:

- -- On S Corporations having no E&P;
- -- On S Corporations which have E&P due to prior C periods; and
- -- Introduces the concept of an accumulated adjustments account.

These new rules are necessitated because of the desirability of permitting the distribution of appreciated property, and avoiding the adoption of complex rules akin to Code section 751(b).

Technical Comments.

General.

When the rules under this proposed section are read in conjunction with the proposed section 1379 transition rules, a tax trap for the unwary, unsophisticated, small businessman arises. These rules in essence provide for a one year period in which previously taxed but undistributed income of a previously electing Subchapter S Corporation may be withdrawn without being taxed twice. This transition rule may be confiscatory even to the best advised shareholder because they may not be able to make the distribution within the required one year period.

We highly recommend that:

-- The transition rule of proposed section 1379(c) be amended to permit unlimited withdrawals of previously taxed but undistributed income ahead of accumulated earnings and profits; or

-- The accumulated adjustments account be refashioned to include all previously taxed but undistributed income.

Accumulated Adjustments Account.

After examining the definition of the "accumulated adjustments account" in proposed section 1368(e)(1) we are uncertain what those "similar adjustments" described in proposed section 1367 are, and how they would be applied to arrive at the computed accumulated adjustment account balance. Certainly one cannot expect a small businessman to devine what is meant. The failure to spell out these adjustments may promote unnecessary and time consuming audit adjustments.

We strongly recommend that the Congress describe with particularity the nature of each item making up the accumulated adjustments account, and how the increases and decreases in the accumulated adjustment account will work.

S Period.

We recommend that the term S period include the period from January 1, 1959, or the date a Subchapter S election was made, if the election was in effect as of the effective date of this Bill.

Section 1371. Coordination with Subchapter C.

Summary.

This proposed section has no counterpart in prior law. It adopts rules with respect to:

-- Application of Subchapter C to an S Corporation.

-- Carryovers between C year and S year corporations.

-- Adjustments to the earnings and profits account.

- -- Coordination of the investment credit recapture rules.
- -- Distribution by the corporation after a terminating event.

Technical Comments.

Earnings and Profits.

The Joint Committee Recommendations at 18 states that after enactment of the Bill, if a Subchapter S election is in effect, the corporation would have no earnings and profits for that year. Although we understand this concept is intended to be in the current Bill, it is not explicitely set forth in proposed section 1371(c)(1). This proposed section should be revised to include this important concept.

Cash Distribution.

Proposed section 1371(e) must be read in conjunction with proposed section 1377(b) which defines the post-termination transition period. The permitted one year period for withdrawing S year undistributed income is too short for an operating company. The shareholders in small corporations bear an unjust burden when the corporation cannot timely liquidate assets to meet the one year cash rule. They would never be able to withdraw previously taxed but undistributed income except when their stock in the corporation is sold.

At a time when Congress is wrestling with ways to reduce the government burdens on small business, another alternative may be to incorporate a reordering provision which allows such distribution to come ahead of a distribution out of accumulated earnings and profits if termination occurs.

We believe the better solution is to extend the withdrawal period for an unlimited time period.

Section 1372. Coordination With Part I Of Subchapter D, Etc.

Summary.

This proposed section takes completely away all of the fringe benefits regular corporations enjoy.

- -- The $5,000 death benefit exclusion (Code Section 101).

-- The exclusion from income for amounts paid from accident and health plans (Code Section 105).

-- The exclusion from income for amounts paid an employer to an accident and health plan (Code Section 106).

-- The group-term life insurance exclusion of up to $50,000 on an employee's life (Code Section 79).

-- The exclusion from income of meals or lodging furnished for the convenience of the employer (Code Section 119).

Technical Comments

General

During the last ten years Congress has been very much concerned about employee fringe benefits. It has adopted the Employees Retirement Income Security Act of 1974, P.L. 93-406, 93rd Cong. 1st Session (1974); and has adopted extensive anti-descrimination rules in other fringe benefit areas. The principal objective of Congress should be to place all employees on the same footing regardless of the choice of business entity the employer selected. Both partnerships and S corporation employees should be permitted to enjoy the same fringe benefits as their C corporation counterparts.

If Congress, in its wisdom, feels that fringe benefits are too great of a revenue loss, they should repeal the fringe benefits for all, not just a select few.

We feel that this proposed section should be deleted in its entirety.

Section 1373. Foreign Income.

Summary.

This proposed section has no counterpart under current law. It identifies those instances when an S corporation will be treated as a partnership, and the making or terminating of an S election triggers the recapture of overall foreign losses.

Technical Comments.

Recapture.

We do not understand why the making or terminating of an S election should be treated as a disposition of a business. We believe there may be better alternatives.

Section 1374. Tax Imposed on Certain Capital Gains.

Summary.

Proposed section 1374 is divided into four subsections. The first three follow nearly word for words subsections (a), (b) and (c) of Code section 1378, which imposes a tax at capital gains rates on certain corporate transactions. The fourth subsection is new, and is made necessary by the changed concept of S corporation taxable income introduced by proposed sections 1363 and 1366. For purposes of retaining the corporate level tax on certain S corporation long term capital gains, proposed section 1374(d) creates a second computation of taxable income, requiring it be calculated as in the case of C corporations, but without the net operating loss deduction of code section 172, and without the special deductions for corporations other than for organizational expenses.

Although many believe present section 1378 is ineffective in accomplishing the objective to which it was directed (preventing a C corporation from electing under subchapter S before a sale of capital gain property to avoid the two tier tax), continuing the tax is appropriate in the context of the current Bill. However, if the proposal to eliminate C corporation accumulated earnings and profits through a toll charge is adopted, proposed section 1374 must be limited in application to those S corporations which have accumulated earnings and profits and which do not elect to pay the toll charge.

We propose, with respect to proposed section 1374 imposing a corporate level tax on the S corporation with substantial capital gain, a somewhat broader application than H.R. 6055 provides as to a corporation with E&P electing S corporation status but not electing to pay a toll charge at the shareholder level to purge itself of accumulated E&P. It should apply if the election has not been in effect for at least five years. It should also apply to an installment sale made during the five year period following the S corporation election to the extent principal is paid during the five year period.

Technical Comments.

Taxable Income Determination.

Proposed Section 1374(d) uses a different set of rules for calculating taxable income than is used under proposed sections 1363 and 1366 in determining the amount of the shareholder's pass-through income. This complexity seems unnecessary. We suggest that proposed section 1363 rules for calculating taxable income (since the calculations must be made anyway), without the subsection (c)(2) exceptions, is far more simple and will not provide a distorted result.

The reference to "Part VII" in proposed section 1374(d)(2) should be a reference to "part VIII."

Section 1375. Administration.

Summary.

This proposed section has no counterpart in current law. For ease in administering the tax laws an entity level audit aproach is adopted. The tax treatment of any Subchapter S item of income, loss, deduction, or credit is determined at the corporate level. Provision is made for each shareholder to participate in any administration or judicial proceeding to determine such items.

Technical Comments.

Proceedings.

Proposed section 1375(c) does not explain what is meant by an "opportunity to participate." Is it contemplated that each shareholder and his authorized representative will be permitted to comment upon, be present during, or be a party to, each and every contact between the IRS personnel and the corporation? To avoid unnecessary and unproductive use of monetary resources and time of both the taxpayer and the government, the phrase "opportunity to participate" should be defined.

Recommendation.

Proposed section 1375(d) should clarify what rules will be in effect until the Secretary's recommendations are acted upon by Congress. Furthermore, this proposed section should require that such recommendations be submitted in written form, and that further public hearings be held regarding the Secretary's recommendations.

This proposed subsection does not address how a shareholder's individual rights are to be protected in an audit. This omission greatly concerns the Section of Taxation. The Secretary should be directed to include such recommendations in his report.

Section 1377. Definitions and Special Rule.

Summary.

The definitions in this proposed section are new. They have no counterpart in current law. The terms "prorata share" and "post-termination transition period" are defined, and the Secretary is given authority to adopt regulations governing the manner in which the Subchapter S election is to be made.

Technical Comments.

Termination Election.

Upon termination, proposed section 1377(a)(2) permits split taxable years upon the unanimous consent of all shareholders during the year. This rule is too inflexible. It should be modified to require the unanimous consent of all shareholders as of the date the tax year is to be split. Consent of those persons who become shareholders after the effective date of the split year should not be able to upset the carefully laid termination plans of shareholders as of the date of termination.

If the potential shareholders do not like the split year, they need not become shareholders.

Transition Period.

The time lapse between the date identified in proposed section 1377(b)(a)(A) and 1377(b)(1)(B) may be several years. If the statute of limitations for an audit hasn't run, does this mean the transition period, as a minimum, is extended for the length of the statute of limitation period? This apparently is the intent of this language. If something else is intended, this statutory language should be modified to reflect this.

Section 1378. Taxable Year of S Corporation.

Summary.

Under current law a Subchapter S corporation is permitted to select its accounting period in the same manner as a C corporation. Except for grandfather provisions, this proposed section would force all S Corporations to elect a calendar year.

Technical Comments.

Grandfather rights.

We believe the grandfather clause set forth in proposed section 1378(c)(3) is much too harsh. A corporation should not be forced to adopt a calendar year reporting period when a shareholder transfers stock to his spouse or other family members for estate planning purposes. The adoption of an attribution rule would be a desireable result.

Section 1379. Transitional Rules on Enactment.

Summary.

This proposed section establishes rules for carryforwards and distributions of undistributed taxable income during the year in which the Bill became effective.

Technical Comments.

We feel strongly that proposed section 1379(c)(1) should be modified to permit distribution of undistributed but previously taxed income without any fixed time limit. To do otherwise would subject the small uninformed businessman to a double tax on such distribution. The rule as presently drafted destroys the single tax concept which an electing Subchapter S shareholder thought he had acquired since enactment of Subchapter S in 1958. By keeping the rule as presently drafted Congress will loose faith with small businessmen throughout the country.

Chairman STARK. Dr. Schenken?

STATEMENT OF JERALD R. SCHENKEN, M.D., MEMBER, COUNCIL ON LEGISLATION, AMERICAN MEDICAL ASSOCIATION

Dr. SCHENKEN. Mr. Chairman, my testimony today is made on behalf of the American Medical Association. Joining us in this statement are the American College of Radiology, the American College of Emergency Physicians and the College of American Pathologists.

In the interest of brevity, Mr. Chairman, I will present only an extremely brief summary of our position. This reflects our concern for time but in no way diminishes our concern for the issue.

We support many of the objectives and provisions of the various bills creating safe harbor rules. Although we do support them, clarifying language is required, however, in the case of many physicians.

We appreciate retention of the common law test but feel that these have been and may still be in the future open to unnecessary and costly misinterpretation.

Most physicians have been properly classified as independent contractors generally providing services to patients and not to hospitals. We recognize noncompliance as apparently the single most important issue involved here, and we appreciate the recent IRS study which found, as we believe to be true, that physicians are not a problem. They had better than 96 percent compliance rates in the study.

We are asking for no special treatment or change in our present status under existing common law by and large. What we are suggesting is that several technical clarifying amendments be considered by the committee which will prevent the consequences which we feel are unintended by Congress and undesirable for hospital associated physicians.

Mr. Chairman, that is a brief summary, but I would be happy to answer questions.

Chairman STARK. Thank you very much, Doctor.

[The prepared statement follows:]

STATEMENT OF THE AMERICAN MEDICAL ASSOCIATION, PRESENTED BY JERALD R. SCHENKEN, M.D.

Mr. Chairman and Members of the Committee:

I am Jerald R. Schenken, M.D., a pathologist practicing in Omaha, Nebraska, and I serve as a member of the AMA's Council on Legislation. With me today is Chris Damon of the AMA's Department of Federal Legislation.

Mr. Chairman, my testimony today is made on behalf of the American Medical Association, the American College of Radiology, the American College of Emergency Physicians, and the College of American Pathologists. All of our organizations are concerned about the potential impact of pending independent contractor legislation on the status of hospital-associated physicians for federal tax purposes.

Physicians as Independent Contractors

Mr Chairman, the issue of independent contractor status for physicians goes to the very heart of professionalism. A physician has an ethical and legal obligation to assure that concern for the care of an individual patient is paramount. Hospital-associated physicians, as compared to employed physicians, should be regarded as independent contractors in that there is no attempt to exercise any control or interfere in any way with the physician's independent exercise of medical judgment on behalf of an individual patient. Agreements between physicians and hospitals may require the physician to perform certain services at the hospital, to utilize hospital equipment and ancillary personnel, but not control the exercise of medical judgment on behalf of individual patients. The physician, not the hospital, determines what procedures or treatment will be ordered for the individual patient and professional services are provided to individual patients by hospital-associated physicians in the same manner as by physicians who voluntarily serve on the hospital medical staff.

Historically, hospital-associated physicians have been considered by the Internal Revenue Service to be independent contractors under the common law rules and have not been considered employees of hospitals. This has been confirmed by Revenue Ruling and court decisions. For example, Revenue Ruling 66-274 (1966-2 Cum. Bull., 466) concerned a physician who had contracted with a hospital to serve as Director of its pathology department. The individual was paid a percentage of fees for his services and was required to pay the remuneration of any physicians he hired to assist him, and was permitted to perform services for other hospitals. The ruling held that the physician was not an employee of the hospital. The Pathology Director in question had a right to control his hours worked, was not paid a fixed salary, carried his own insurance, received no fringe benefits as the hospital's other employees, and was free to perform services for others. In its Revenue Rulings on this issue, the Internal Revenue Service has looked at the degree to which the professional had become integrated into the operating organization for which he performs services, the nature, regularity and continuity of his work for the organization, the authority of the organization to require compliance with its general policies, and the degree to which the professional has been accorded the rights and privileges established for the organization's employees generally.

Generally, the basis for determining whether an individual is an employee or an independent contractor for federal tax purposes has been the common law test of control. Under Treasury regulations, if a person engaging the services of another has "the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which the result is accomplished, the relationships of employer and employee is deemed to exist."

Given this standard, Mr. Chairman, it is our view that there is a strong presumption that practicing physicians are independent contractors absent compelling evidence to the contrary. Indeed, the court of highest review which has addressed the independent contractor question for physicians upheld this presumption (Azad vs. U.S., 388 F.2d 74 (8th Cir. 1968)).

In Azad, the U.S. Court of Appeals held that a physician-radiologist who managed the Radiology Department of a hospital was not its employee. Neither the hospital nor the doctor regarded each other as employer-employee. The physician was not controlled or supervised, did not pay rent to the hospital for its facilities, and was not subjected to hospital rules other than those which applied to all members of the medical staff. The physician was paid a percentage of fees of the Radiology Department.

Physicians generally have been considered independent contractors on the basis of their professional status and the control of their work. This is consistent with Treasury Regulation Sec. 31.3401(c)-1(c) which provides:

> "Generally, physicians, lawyers, dentists, veterinarians, contractors, subcontractors, public stenographers, auctioneers, and others who follow an independent trade, business or profession, in which they offer their services to the public, are not employees."

IRS Enforcement Actions and the 1978 Moratorium

In the late 1960s the IRS began to enforce, often arbitrarily, a more stringent interpretation of the common law rules on independent contractors and attempted to reclassify many independent contractors as employees. Hospital-associated physicians were included in these actions. For example, two IRS Private Rulings erroneously held that certain emergency physicians were employees of hospitals. Through a process of selective application of several of the 20 inferential common law factors, the Service reached results that completely departed from the common law control test. In one case the fact that the payor reserved the right to terminate contracts with emergency room physicians for poor performance was deemed sufficient to establish an employee relationship, notwithstanding that the physicians retained the right to refuse work assignments, were not supervised by the payor, received no employee fringe benefits, and were not provided a place of business or a guaranteed minimum income (Private Letter Ruling 7904109, October 27, 1978).

In 1979 the IRS conducted a study concerning income tax compliance by independent contractors. One of the conclusions of the IRS study was that individuals classified as independent contractors were responsible for high rates of noncompliance. However, the study also found that medical professionals showed a very favorable income tax compliance rate of 95.8%.

Because of the problems and uncertainties created by the overly aggresive IRS attempts to reclassify traditional independent contractors as employees, Congress included a provision in the Revenue Act of 1978 that imposed a temporary moratorium on IRS rulings on this issue. The IRS would have to accept a taxpayer's classification of himself as an independent contractor unless the taxpayer had no reasonable basis for independent contractor treatment. Congress has extended this moratorium several times, with the current moratorium scheduled to expire on July 1 of this year. The moratorium and its extensions have been intended to provide time for Congress to address this issue.

Legislative Proposals

In the current Congress a number of bills--including HR 4531, HR 4971, HR 5729, HR 5867, HR 6311, S. 8, S. 2213 and S. 2369--have been introduced to deal with the independent contractor issue. These bills provide that a person will not be considered an employee if all of the following five tests are met:

1. Control of Hours Worked: An independent contractor would have to control the aggregate number of hours actually worked and substantially all of the scheduling of hours worked.
2. Principal Place of Business: An independent contractor cannot maintain a principal place of business. If he does, the principal place of business cannot be provided by the service recipient. If the place of business is provided by the service-recipient, the independent contractor would have to pay rent for the location.
3. Investment or Income Fluctuation: An independent contractor would have to have a substantial investment in assets used in connection with the performance of the service. Alternatively, he would have to risk income fluctuation because his income is directly related to sales or to other output rather than to number of hours actually worked.
4. Written Contract and Notice of Tax Responsibilities: An independent contractor would have to maintain a written contract between himself and the service-recipient. Also, the independent contractor would have to be notified of his responsibility with respect to payment of self-employment federal income taxes.
5. Filing of Returns: Persons or organizations for whom the independent contractor performs his services would be required to file information returns.

Problems for Physicians in the Legislation—Corrective Amendments

Hospital-associated physicians see remedial legislation as being helpful in seeking a solution in that it attempts to create an objective definition of a working relationship that will be considered an independent contractor relationship. With the moratorium due to expire in July, a legislative test would act as a buffer to attempts by IRS to set its own guidelines.

The legislation has been written to fit the circumstances of non-physician independent contractors, such as salesmen, real estate agents, insurance salesmen, etc. We are concerned that it fails to take into account the unique circumstances of professionals, such as hospital-associated physicians. Our concern is that the five tests establishing the "safe harbor," as currently written, could permit IRS to assert that certain physician independent contractors are employees for tax purposes. We have developed draft language to amend the bill to help assure that qualifying physicians who traditionally have been considered independent contractors not be improperly reclassified as employees as a result of the proposed legislation. These amendments are attached to this statement. Adoption of these amendments would resolve the independent contractor issue for hospital-associated physicians, thereby relieving both the IRS and these physicians from the expense involved in continued challenges and litigation concerning this issue.

I will now discuss the problems we see with some of the safe harbor tests in the bills and also discuss our amendments addressing each problem.

Control of Hours Worked

Problem: While hospital-associated physicians generally work during shifts that the physician chooses to work, they often work longer hours than they originally chose because of the volume of patient needs and the physician's feeling of professional responsibility. Physicians are always subject to being called on to work unscheduled hours in the event of a medical emergency. The hours actually worked by a hospital-associated physician may not be completely in his control in the absolute sense implied by the legislative proposals.

Suggested amendment: Our draft amendments would modify the legislation to provide that, so long as an individual has the right to control hours worked, he would be deemed to have satisfied the test even if, in actuality, his control might be less than complete, due to professional obligations to work beyond chosen hours as a result of patient flow or emergencies. We would also ask the Committee to recognize in its report that, if an individual can periodically choose how many hours he desires to work and when he wants to work them, he will be deemed to have satisfied this test.

Principal Place of Business

Problem: This test provides that an independent contractor must not maintain a principal place of business and that if he does, the principal place of business cannot be provided by the person he provides services to unless he pays rent. It could be argued that a hospital-associated physician who performs services at a single hospital on a full-time basis (but with control of work hours and scheduling) is maintaining a principal place of business at the hospital. Our concern is that the IRS might consider the recipient of the physician's services to be the hospital rather than the physician's patients. If the IRS were to so construe the matter, physicians would be deemed to be maintaining a principal place of business provided by the hospital and would not be considered independent contractors.

Suggested amendment: Our amendment package would modify the second test relating to principal place of business to provide that a person will not be deemed to have a principal place of business if he is a licensed professional who is not required to render services exclusively for a single person or entity. For further clarification, we would ask the Committee to recognize in its report that, with regard to hospital-associated physicians, it is the patient and not the hospital that is the service recipient. Medical services are performed for the patient without regard to the location where those services are performed.

Substantial Investment of Assets/Income Fluctuation Test

Problem: This test requires that an independent contractor either have a substantial investment of assets used in connection with performance of his service or risk income fluctuations because his income is based on sales or other output rather than hours actually worked. There are two concerns here. First, the bill could be read as only relating to substantial investment of tangible assets and may not take into account a physician's substantial, but less tangible, investment of time and money in his professional education and training. Second, while most hospital-associated physicians would satisfy the income fluctuation test, since their remuneration is based on direct patient fees or a percentage of fees collected for physicians by the hospital, other physicians may work on a negotiated fee based on hours of service. Those working on negotiated fees would have difficulties meeting the second part of the test.

Suggested amendment: Our suggested amendment to this test would add language to provide that investment in assets would also include investment in education and training leading to professional expertise and formal licensing, certification or registration. We ask the Committee to recognize that for some professions, such as law, accounting and medicine, there is a substantial investment in training and education, and that this training and education should be considered an asset.

Written Contract Requirement

Problem: Many physicians practice in hospitals on the basis of appointment to the medical staff. Others practice on the basis of a handshake with the Administrator or Chairman of the Board. Still others practice on the basis of unilateral letter of understanding. Others do have bilateral contracts which meet the normal definition of that term. Requiring a written contract in all cases would unnecessarily alter present arrangements. Furthermore, since we have asked the Committee to consider the patient and not the hospital to be considered the service recipient for purposes of meeting the "place of business" test, consistent application of that concept would mean that the physician would have to have a written contract with every patient treated, and the patient would be responsible for providing the physician with a notice of the physician's tax responsibilities. This would, of course, be an unwieldly administrative requirement to impose on physicians wanting to comply with the proposed legislation.

Suggested amendment: The AMA amendment would remove the word "written" from the contract requirement so that implied and oral contracts and other informal agreements could be recognized as satisfying the test. The amendment also makes receipt of notice of tax responsibilities optional.

A Final Amendment: In addition to the above discussed amendments relating to specific tests, we also propose another amendment. As currently constructed, the legislation would require independent contractors to meet all five of the tests to be sheltered within the "safe harbor." Because of the potential ambiguities in the application of each of these tests, especially with regard to physicians, we would recommend that the bill be amended to provide that a person is an independent contractor if he meets four of the five tests. Such a change would give added assurance that physician independent contractors will not be improperly classified as employees through misapplication of technical provisions in any one of the safe harbor tests.

A copy of the amendments we have discussed today is attached to this statement. These amendments have been endorsed by the AMA, the American College of Radiology, the American College of Emergency Physicians and the College of American Pathologists.

CONCLUSION

Mr. Chairman, with the upcoming expiration of the moratorium, there is a need for Congress to act on this issue to prevent a return to the situation where the IRS sets its own guidelines. Such Congressional action would remove confusion among those who wish properly to comply with the tax laws and who want to know what they must do to continue to be characterized as independent contractors. In addition, we are concerned that further unwarranted reclassification of physicians as employees would disrupt long-standing independent contractor relationships. This result cannot be justified in the name of tax compliance, inasmuch as it has been shown that physicians pay their taxes faithfully. Because we believe the present legislative proposals do not adequately address the situation of hospital-associated physicians, we urge the Committee to modify the legislation by adopting the amendments which we have prepared. With these amendments, we support the passage of legislation to clarify independent contractor tax status. The AMA and other interested physician organizations would be pleased to work with the Committee in achieving an appropriate result in this matter.

Mr. Chairman, I would be pleased to respond to any questions that the Committee may have.

0535p

March 1982

AMENDMENTS TO INDEPENDENT CONTRACTOR LEGISLATION

The following legislative language would amend legislation (such as S 8 and HR 4531 in the 97th Congress) intending to clarify the tax status of independent contractors. The purpose of the AMA amendments is to help assure that hospital-based and hospital-associated physicians who wish to be considered independent contractors will not be improperly reclassified as employees as a result of the legislation.

There are five amendments to the independent contractor legislation. Currently, pending legislation would require that an independent contractor meet five tests spelled out in the legislation. The first AMA amendment alters this requirement to provide that an independent contractor need only meet four of the five tests to qualify.

The second amendment relates to the first "safe harbor" test relating to control of hours worked. The AMA amendment provides that, as long as the individual either controls or "has the right to control" hours worked, he or she will satisfy the test. This language recognizes that while hospital-based physicians generally work during shifts that the physician chooses to work, they often work longer hours than they originally chose due to the volume of patient needs and the physician's feeling of personal responsibility. The amendment will recognize that, as long as an individual has the right to control hours worked and can periodically choose how many hours he will work, he will have satisfied the test even if in actuality his control might be less than total due to professional obligations and unpredictable patient flow.

The third amendment relates to the second "safe harbor" test regarding place of business. In current pending legislation, an independent contractor cannot maintain a principal place of business. The AMA would exempt from this requirment licensed professionals who are not required to render services exclusively for a single person or entity.

- American Medical Association -
Department of Federal Legislation, Division of Legislative Activities

The fourth amendment relates to the third "safe harbor" test regarding investment in assets or income fluctuation. The AMA amendment would provide that investment in assets would also include investment in education and training providing professional expertise and formal licensing, certification, or registration. This provision is included because the current pending legislation could be read as only relating to a substantial investment in tangible assets and equipment and many hospital-based physicians may not have made this kind of investment. Also, the second part of the test could not be met by some physicians who may work on a negotiated fee based on hours of service thereby precluding wide fluctuations in income.

The final amendment deals with the fourth test relating to a written contract requirement. Many physicians currently practice in hospitals without any formal written contracts. Also, it is the patient and not the hospital that is the recipient of the physician's services and a written contract with every patient would be administratively impractical. The AMA amendment would remove the word "written" from the contract requirement so that implied and oral contracts could be recognized as satisfying the test. The amendment also makes receipt of notice of tax responsibilities optional.

FIVE DRAFT AMENDMENTS TO S 8, "EMPLOYMENT TAX ACT OF 1981" AND TO HR 4531, "INDEPENDENT CONTRACTOR TAX STATUS CLARIFICATION ACT OF 1981"

(New language underlined; language to be deleted lined-out.)

(1) In proposed Section 3508, amend subsection (b) as follows:

> "(b) REQUIREMENTS. —For purposes of subsection (a), the requirements of this subsection are met with respect to service performed by any individual if four of the following five conditions are met—

(2) Amend Section 3508(b)(1) as follows:

> "(1) CONTROL OF HOURS WORKED. —The individual controls or has the right to control the aggregate number of hours actually worked and substantially all of the scheduling of the hours worked."

(3) Amend Section 3508(b)(2) as follows:

> "(2) PLACE OF BUSINESS. —The individual does not maintain a principal place of business, or, if he does so, his principal place of business is not provided by the person for whom such service is performed, or, if it is so provided, the individual pays such person rent therefor. For purposes of this paragraph, the individual shall be deemed not to have a principal place of business if he does not perform substantially all the service at a single fixed location - , or, in the case of a licensed professional, if he is not required to render services exclusively for a single person or entity."

(4) Amend Section 3508(b)(3) as follows:

> "(3) INVESTMENT OR INCOME FLUCTUATION. —
>
> "(A)
> The individual has a substantial investment in assets, or an investment in education and training providing professional expertise and formal licensing, certification or registration, used in connection with the performance of the service, or
>
> (B)
> The individual risks income fluctuation because his renumeration with respect to such service is directly related to sale or other output rather than number of hours actually worked."

(5) Amend Section 3508(b)(4) as follows:

(4) ~~WRITTEN~~ CONTRACT ~~AND~~ OR NOTICE OF TAX RESPONSIBILITIES

"(A)
The individual performs the service pursuant to a ~~written~~ contract between the individual and the person for whom such service is performed—

"(i) which was entered into before the performance of the service, and

"(ii) which provides that the individual will not be treated as an employee with respect to such service for purposes of the Federal Insurance Contributions Act, the Social Security Act, the Federal Unemployment Tax Act, and income tax withholding at source, ~~and~~ or

"(B)
The individual is provided written notice, in such contract or at the time such contract is executed, of his responsibility with respect to the payment of self-employment and Federal income taxes.

Chairman STARK. Mr. Hall.

STATEMENT OF RAYMOND J. HALL, EXECUTIVE VICE PRESIDENT, ELECTRONIC REPRESENTATIVES ASSOCIATION, REPRESENTING THE SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. HALL. My name is Raymond Hall. I represent the Small Business Legislative Council. As a member of that council, our association, the Electronic Representatives Association, is supporting this legislation. We have an association made up of manufacturers' representatives, and there are about 2,000 members now. These are companies and they operate as such.

We represent about 15 billion dollars' worth of sales in the electronics industry. This function represents over 25 billion dollars' worth of sales in the electronics industry. This has been a major issue among our membership and all of the manufacturers' representatives, and the majority of associations of small business people that represent the Small Business Legislative Council.

If some clarification is not made, we are going to go back to what appears to be harassment. The problem occurred because of the lack of this type of legislation on the part of the IRS agents who are calling upon the small business community and the people involved as independent contractors, and the lack of clarifications in definitions.

They—IRS agents—are unknowledgeable about the business that is involved and the size and the impact of it. Legislation such as this will help clarify that, and it will put us in a position to allow the tens of thousands of companies who operate as independent contractors, individuals who operate as independent contractors, whose function isn't easily defined—as easily as the more common functions as the medical professions and so many others in distribution and retailing—to operate on an independent basis. There is a lot of clarification that comes out of this type of legislation that we all need.

Interestingly enough, I think if this type of a hearing and this type of activity occurs more often in the future aimed toward the business community, there is going to be an overwhelming response on the part of those people affected by this type of legislation or the lack thereof, on how they are negatively affected by the position they have as independent contractors; if they are going to be challenged in the future.

I think there is a lot of people in the business community that are not aware of this legislation, a lot of associations and functions that are not involved at this point, so that if this legislation is not passed in some form or another then there is going to have to be more legislative activity and more dedication to penetrating the business community.

I mention those numbers, by the way, $25 billion as affected by just one the independent manufacturers' representative function in one industry. That is $250 billion if you consider all manufacturers' representatives or independent agents operating out there, and that is just one function of all the functions we are talking about to be affected as independent contractors.

Chairman STARK. You can help the deficit.

Mr. HALL. We could contribute it for 1 year. It's larger than most people are aware, and that is the impact of this. This is kind of the unspoken group. We are not the only ones. There are a lot of them in the council, and that is what we are concerned with.

We are in favor of the legislation. We are in favor of some form of definitiveness. As far as compliance, I listened to all the testimony. You say we are not going to talk about compliance, but all of it involves compliance. However, we don't see much of the compliance problem in our industry. Our people are either corporations or sole proprietors. If they are sole proprietors, they seem to have a tendency to want to become incorporated to protect themselves against this type of situation, and that is wrong. You should be able to operate as a proprietor or partnership or corporation based on your operation and necessities rather than to avoid taxes or avoid an issue such as this. That is a major problem for us.

If we get into the problem as far as the definitions as to whether you are a contractor or not, by the use of a contract, and all the business is going to be done by contract in the future, and we don't have a problem with that in our industry. We can tell you that many of the industries, there are people qualified as independent sales operators, salespeople without contracts, without written contracts. If that form has to come about, and maybe it will, but I think that we shouldn't force the issuance of a written contract over an oral contract just for that reason.

There is a great deal of confusion among the people that we represent, the small business people, as to what this legislation means. We would like to make sure that the committee—with as much influence as we can have on the committee—will find a way to get more of this information out on this legislation to the tens of thousands of small business people who are now classified as independent contractors, and could have that position in jeopardy if there is no legislation or clarification of the 1954 act.

Thank you.

[The prepared statement follows:]

STATEMENT OF RAYMOND J. HALL ON BEHALF OF SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. Chairman and members of the subcommittee, my name is Raymond J. Hall, and I am the Executive Vice President of the Electronic Representatives Association of Chicago. Our association has 1,500 member firms representing more than 7,000 professional manufacturers' salesmen.

I am appearing here today on behalf of the Small Business Legislative Council (SBLC), an organization of 70 national trade and professional associations and their affiliates representing over 4 million small businesses throughout the country.

Independent contractors are an integral part of the small business community which the SBLC represents. For example, the regular membership in some of SBLC's associations consists entirely of independent contractors. Altogether in this country, there are approximately 45,000 manufacturers' agencies each employing an average of five salesmen, all independent contractors, and representing not one manufacturing firm, but several. Together they sell an astounding $197 billion of this nation's gross national product, dealing in all products from food stuff to heavy machinery. This is the most efficient marketing force known today—the most economical means of transferring goods for money in existence. To jeopardize this system, which works so well, to get at the occasional offender posing as an independent contractor, will do great injury to our nation's economic well-being. For this reason SBLC supported the interim relief granted to taxpayers in Section 530 of the Revenue Act of 1978, the extension in 1980, and now lends its full support to H.R.

6311, the bill recently reintroduced by Congressmen Richard Gephardt and Barber Conable, which has had over one hundred co-sponsors in past sessions of Congress.

Prior to the legislative action taken by the Congress to impose a moratorium upon reclassification, the Internal Revenue service had initiated a campaign in some areas of the country to challenge and alter the tax status of small business people filing as independent contractors. Despite repeated defeats in the courts and sharp criticism from the GAO, the IRS had increased pressure for changes in the basic make-up of the industries utilizing this status—that is reclassification of the independent contractors from small business people to employees of companies. The major motivations of the IRS in justifying reclassification appeared to be a desire to correct alleged under-reporting of income by independent contractors, to bolster the Social Security trust fund by changing from a self-employed payment system to a FICA system, and to provide unemployment compensation to these individuals.

Under the Carter Administration, the Treasury Department supported the position of the IRS and considered radically revamping the requirements one must meet to be classified as an independent contractor. The changes then proposed could have effectively eliminated millions of small business careers throughout the country.

The SBLC recognized then, as it does now, the need for workable and definitive criteria for independent contractor status. This is especially true in light of the expiration at the end of June of this year of Section 530, the interim solution adopted by Congress. Continued uncertainty in this area can have a negative impact on growth of industries to which the use of independent contractors is critical. The impact will be most harshly felt by smaller companies which do not have the flexibility or finances to restructure a marketing force or their whole way of doing business.

The SBLC has formally adopted the position, supported by a majority of our associations, that the independent contractor is an integral part of our economy and is essential if individual entrepreneurship and small business is to flourish in this country. The reclassification of independent contractors as employees would be anti-small business, with an adverse effect on the job market, as well as causing an adverse effect on anti-inflation efforts by increasing costs of doing business and reducing competition. The SBLC supports legislative initiatives such as H.R. 6311.

H.R. 6311 provides a necessary safe harbor test, and retains for the millions of small businesspeople operating under it, the common-law test. The bill provides certainty for those industries where IRS has attempted to reclassify independent contractors and would preserve the status of those small businesspeople who have historically been treated as independent contractors.

Most significant, though, is the bill's five-pronged test for safe harbor protection. Where the following criteria are not fully met, the common-law test definition of an employee would be applied. The independent contractor: (1) controls number of hours worked; (2) is not provided with a place of business by the person for whom services are performed; (3) has complete freedom in capital investment and income; (4) signs a written contract stating tax responsibilties, and (5) files required returns with the Internal Revenue Service.

These five criteria provide the legislative mandate necessary to clarify who is an independent contractor. And in those cases where not all tests are met, the tax status will be judged by common-law tests. Small businesses utilizing independent contractors and independent contractors themselves will benefit immeasurably from the certainty that this legislation provides. Moreover, the requirement of written contracts and notification to independent contractors of tax responsibilities and the requirement of filing informational returns as intended by the bill will give both IRS and independent contractors additional information to improve tax compliance.

While the Administration has not advanced the proposition of withholding upon independent contractors and we do not expect them to do so since the President pledged his opposition to withholding during his campaigning, SBLC wishes to take this opportunity to vigorously oppose any proposal that includes withholding of payments including contracts. The mere implementation of any withholding procedure is inconsistent with the relationship of the entities involved, is tremendously costly for the payer, and is potentially destructive of the incentive of entrepreneurial initiative. We are aware of enhanced reporting requirements that are being considered in both the Senate and the House, as well as within the Administration. SBLC supports increased penalties for failure to file 1099 forms, and endorses increased funding for IRS computer reporting to help the effectiveness of the program. But any new reporting burdens placed upon companies using independent contractors should be done extremely judiciously, and the cost related to compliance with these reporting requirements should obviously be given heavy weight before enactment. Therefore, SBLC would oppose Administration or Congressional proposals that unduly burdened small business and which could not have been shown to have significant positive impact on the public interest. The burden must be upon the proponents of any new reporting system to show that the benefits far outweigh the costs to the companies involved. Legislation should not be adopted in this area merely because there is pressure to do "something, anything," that appears, and we stress appears, to be of help in reducing the deficit by a speculative proposal to increase tax compliance for independent contractors.

In addition, SBLC has serious reservations about some Treasury suggestions because of the administrative costs involved in withholding. Institution and maintenance of recordkeeping, changes in accounting systems, etc., especially in industries where the independent contractor enters and leaves the industry frequently, could be burdensome, particularly for smaller companies that have very little ability to absorb such costs.

These increased costs could also result in some industries phasing out parttime, low earning individuals in order to balance increased costs to companies for administering a withholding program. The withholding suggestion, by increasing costs and paperwork, runs counter to Administration assertions that it would reduce these kinds of burdens for small business.

Chairman **Stark**. Thank you, Mr. Hall.

I would just like to assure all of the witnesses, because each of you in this panel, have a particular interest, that this committee wants to make sure that we find a solution that will take into account each of your legitimate interests. While we did say that compliance is not part of this hearing, I think that is defined in the narrow sense of collecting the tax, and what procedure will be used. That is the subject of another bill that will be reviewed by the full committee.

Mr. Koplan, some people may not be getting social security benefits. Generally those tend to be people of very modest means to whom social security will some day be very important. Mr. Hall, it may not affect some of your members as they tend to be in a higher income group than the people that depend on social security.

We have to consider all of those types. We have to consider the professions. We will have to compromise because it is very hard to draft something that fit each person's particular concerns. If it seems that we are going ponderously slow—I am sure that you haven't sat through these hearings before. They are tremendously complex, and it is very hard to please everybody, but we are going to try.

Mr. Duncan.

Mr. **Duncan**. I have no questions.

Chairman **Stark**. Mr. Guarini.

Mr. **Guarini**. Let me ask Mr. Hall. The computer industry is a very fast-growing new industry. Are you saying that the growth of the computer industry would be affected by broadening the basis of the independent contractor, that that is what you would want, so that you could grow faster as an industry?

Mr. **Hall**. Very definitely. The vast majority of manufacturers who produce computer and computer-related products today use sales reps—an example of that would be looking at the National Computer Conference and just taking all those exhibited on the floor, probably 80 percent utilize independent sales organizations, independent sales representatives and agencies to sell and market their products.

And if their positions as independent contractors came into jeopardy, if their manufacturers had to withhold taxes, if the papework was an encumbrance on using the independent sales rep, it would very definitely affect the most significant form of distribution used in getting product to market, in that industry.

Mr. GUARINI. While I can be sympathetic and understand—of course, that would be true in almost every industry, whether a new one or an old one. I am wondering whether or not the way that you are organized as an industry, that you are training people and informing them that they can go out and work on a commission basis, and make $20,000, $30,000, $40,000 a year in just noncommissioned sales.

Of course, that would give a tremendous edge to that kind of employee, as opposed to a traditional type of an employee. Is it the expectation of these people that they are going to be independent contractors, and that they are going to be just working on a commission, a pure commission?

Mr. HALL. It is the incentive of operating on their own, and the ability to make a profit or make as much money as they can, operating on their own as an independent.

Mr. GUARINI. I know someone that just went through a training program, for Radio Shack say, and was told that you can start earning $25,000 your first year out. It is a very lucrative commission, and a very advantageous position. Now, what would you say, if you take that one particular case, a person should be expected to pay as income tax to the Government?

Mr. HALL. In the case of Radio Shack——

Mr. GUARINI. No withholding tax.

Mr. HALL. Radio Shack is a direct employee user. That is, not independent contractors. The people that work for them are employees, and they have all the benefits of being employees, including reduced social security out of their pocket, the benefits that Radio Shack provides for all their employees.

Mr. GUARINI. That is for their employees?

Mr. HALL. Right.

Mr. GUARINI. But the people they use as salesmen on commissions to go out into the field and to sell the computers to the businesses and to the homes, et cetera, I understand that they are being more or less encouraged to become independent contractors, which keeps the cost of the corporation down, because the more people they have out there selling——

Mr. HALL. This is an interesting diffusion of this whole process and a very good example.

Mr. GUARINI. That is why I asked you the question. I would like you to answer.

Mr. HALL. What happens here, you have the implication that the employer is creating some alternative form of employment for someone by his action. In fact, what happens is that Radio Shack says, "We are looking for independent commissioned salespeople to take on our line."

Mr. GUARINI. We are not talking about, of course, people who are making a couple hundred dollars a month, or anything like that, like a housewife doing something on the side. We are talking about big money?

Mr. HALL. Absolutely.

Mr. GUARINI. And very healthy salaries that these people can draw down. And they should have no withholding tax taken out as far as you are concerned?

Mr. HALL. If they are operating on an independent basis—and for the most part those people can take on other lines. One of the things that makes them an independent sales rep is the ability to carry other lines, compatible noncompeting lines. Automatically that person becomes an independent manufacturers' representative, and that is one of the most important functions of a free enterprise systems we have. It is huge in this country.

Mr. GUARINI. If they have their own company, of course, I understand.

Mr. HALL. Sure.

Mr. GUARINI. But if they are just a private individual operating out of a house and they start taking a car and their home off and the company doesn't have to pay any social security taxes, doesn't have to pay any unemployment tax, workmen's compensation, do all the bookkeeping.

Mr. HALL. Right, they are in business for themselves, aren't they?

Mr. GUARINI. What you are saying, that this individual is being more or less brought along with the philosophy that they could operate and make $25,000 and upwards a year by selling computer equipment out of their home, and not have to have any withholding taxes or any concerns about what an average employee has to be concerned about.

Mr. HALL. If they are going to do that, I will answer you very straightforward, the $25,000 figure doesn't make any sense. They wouldn't make $25,000 a year gross and pay all their expenses out of that and make a living as an independent commissioned salesperson. If they are going to be an independent commissioned salesperson, that would be more of a net figure than a gross, because they are going to pay their car expenses.

All that company is going to do is pay them a commission for whatever they sell, and when that happens, that person is an independent contractor, relying upon their own ability and their ability to sell, to be able to fulfill themselves. They have to work hard and they only make money if they sell something.

Mr. GUARINI. I see your position.

Dr. Schenken, just one question. In regard to hospitals, would you restate your position. Take a radiologist who often, of course, can make a couple hundred thousand dollars a year for which he gets paid from the hospital directly. You consider him an independent contractor even though he is under contract with the hospital. All doctors should be independent contractors; is that the thrust?

Dr. SCHENKEN. No, it is not the position. We have physicians who are listed in their contract as employees, and if they are, they fall under employee classification.

We have a large number of physicians, however, who work for hospitals in the sense that they are in the hospital providing services to the patients, and they agree to it, but they are functioning as independent contractors. Some of the money flows through the hospital. Some goes directly. Those are presently classified as independent contractors, and all we are asking is that they continue to be. We are not asking for change of those who are truly employees to a nonemployee status.

Mr. GUARINI. Thank you.

Chairman STARK. I am afraid that in my own confusion I overlooked Mr. Seifert, who I thought was accompanying Mr. Hall. Mr. Seifert, I apologize. Why don't you summarize your statement for us.

STATEMENT OF RANDOLPH J. SEIFERT, GENERAL COUNSEL, NATIONAL REMODELERS ASSOCIATION/NATIONAL HOME IMPROVEMENT COUNCIL, ON BEHALF OF THE SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. SEIFERT. Thank you, Mr. Chairman. Our written comments are before you. Just very briefly, we would like to add that we appreciate the interest that Congress has shown in the safe harbor approach to a very difficult problem within our industry, that is, the classification of those workers who do so much for the homebuilding community in America.

There are well over 100,000 remodeling contractors who use some 20-plus types of subcontractors.

Chairman STARK. Where is my tile man, by the way? He has not showed up for 2 weeks.

Mr. SEIFERT. I am sure that he will be in touch.

Chairman STARK. He is supposed to do my kitchen. I am glad you are here.

Mr. SEIFERT. Let us know how we can help, Mr. Chairman.

We very much support the safe harbor test; we support H.R. 6311, and we support the view that there can be both a safe harbor and a common law test that allows in some instances those of our people who will not meet safe harbor to qualify under common law.

We would be very much concerned were there a withholding provision. Most of our contractors are in a small family business, two or three in a family. They do not have that electronic competence that Mr. Hall spoke of, nor are they qualified to set up a complex bookkeeping and withholding system.

We very much like the approach of 6311 in minimizing withholding. We think that your approach in 6311 with respect to compliance is an equitable attempt to meet and bring people into line with an evenhanded approach to this issue. Finally, we believe that the definition of employee should have a congressional resolution, not one by the IRS.

For your patience over the years, and for your willingness to hear of this tax unfairness at first hand, we are most grateful. You have served the total community well, in educating all of our industries and you have done an outstanding job in bringing to the attention of all a problem that reaches into the entire country.

[The prepared statement follows:]

STATEMENT OF RANDOLPH J. SEIFERT ON BEHALF OF NATIONAL REMODELERS ASSOCIATION/NATIONAL HOME IMPROVEMENT COUNCIL

Mr. Chairman and Members of the Subcommittee, my name is Randolph J. Seifert, and I am the Vice President and General Counsel of National Remodelers Association/National Home Improvement Council (NRA/NHIC). Our association has more than 4,000 member firms representing all segments of the light residential and remodeling industry.

NRA/NHIC is a member of the Small Business Legislative Council, and heartily endorses the statement of that organization, given by Raymond J. Hall, before your subcommittee.

The Small Business Legislative Council is an organization of 69 national trade and professional associations and their affiliates representing over 4 million small businesses throughout the country.

The NRA/NHIC is appreciative of this opportunity to present our views in support of H.R. 6311 recently introduced by Congressman Richard Gephardt and Barber Conable.

We urge that the subcommittee favorably report this bill.

This legislation would accomplish the following:

Provide reasonable long-term standards which establish an alternative method of determining whether an individual is an employee or an independent contractor;

Provide a "safe harbor" by giving certainty as to tax status to independent contractors who are able to satisfy the five strict requirements outlined in the bill. However, by retaining the common law test, it will not foreclose independent contractor status to an individual who may not meet all five "safe harbor" provisions. This "safe harbor" approach is important because it would be virtually impossible to design one specific legislation proposal to clearly meet the needs of all the numerous occupations and industries affected by the issue; and

Offer a measure of certainty to those industries, such as the remodeling industry, where the IRS's attempt to reclassify individuals as employees has disrupted business relationships.

Various industry studies show widely differing figures for the number and type of remodeling contractors in the country. The likelihood is that the number is in excess of 100,000 contractors who are generalists in the remodeling room addition and general home improvement business or who are roofing/sliding specialists, kitchen/bath remodelers or insulation contractors. By virtually every applicable federal definition of "small business," the remodeler is included in that definition.

The largest single grouping of remodeling contractors throughout the country is the small entrepreneural family unit that specializes in skilled craftsmanship in a general remodeling, home improvement business with no more than two or three employees. These family units employ people with similar skills and backgrounds. The typical contractor has little if any accounting or business background. He depends essentially on 20 or more separate types of craft specialists or independent subcontractors: the electrical contractor, the sheet metal specialist, the roofer, the brick mason, et cetera. These skilled craftsmen, in their turn, are fiercely independent. They prize their entrepreneural status and do not wish to be designated as "employee." The general contractor cannot exist without these special skills.

Section 530 of the Revenue Act of 1978 was much appreciated by the small business community in America. It recognized that the definition of "employee" in the tax statutes left something to be desired, and afforded an opportunity for IRS harassment. This industry was especially hard hit. Many received claims of the Federal Government for so-called back taxes, penalties and interest of amounts in the 6 and 7 figures—totals that would in almost every instance wipe out a business if the government seriously attempted to collect. And in almost every instance the claim was based on utilization of independent contractors and the attempt by the government to characterize these entrepreneurs as our "employees."

In hearings before a House subcommittee in July of 1979, NHIC testified in support of the earlier Gephardt Bill, H.R. 3245, and heartily endorsed the "safe harbor" test that offered the opportunity for the small businessman to have some degree of assurance that by meeting the five-point test, he would be free of IRS harassment. At the same time, we welcomed the reaffirmation by Congress of the traditional common-law test for those who have been historically treated as independent contractors.

Our support for the safe-harbor approach of H.R. 6311 is based upon our position that remodeling contractors must be able to operate with a degree of certainty that their independent contractor/principal relationship will not come under repeated scrutiny by the Internal Revenue Service. The five-point text provides that certainty.

Our support for the Gephardt bill goes beyond the five points of the independent contractor test, however. The proposed legislation also provides new measures to improve compliance among independent contractors and their payors without imposing an across-the-board automatic and mandatory withholding from payments made to them. The previous Administration proposed such a move, and it was immediately opposed by independent contractor groups such as NRA/NHIC and other member associations of the Small Business Legislative Council. It was our view then, as it is now, that the large majority of remodeling contractors are in compliance with payroll tax requirements through the provisions of the existing 1099 system. The additional recordkeeping requirements imposed on small remodeling contractors would have the effect of placing those contractors in the position of monitoring compliance and collecting taxes for the Internal Revenue Service.

NRA/NHIC remains unalterably opposed to mandatory withholding provisions, and we're happy to note that except in those cases where an independent contractor refuses to voluntarily supply information to the service recipient, that H.R. 6311 has abandoned this coercive approach to payroll tax compliance. We reiterate our continuing support for passage of a statutory definition of independent contractors, and our strong support for efforts to ensure compliance through use of the reporting mechanisms now in place. The 1099 system was established to provide the IRS with the information it needs to monitor tax payments. If that system is somehow deficient, then remedies to correct it must be enacted. But Congress must first ensure that the tax reporting systems currently in place are reliable before seeking to impose additional taxes on those who are already in compliance with the law.

We support H.R. 6311 and its safe-harbor independent contractor test, and we urge this body to adopt this bill's approach and end the uncertainty over this issue which has lingered for so long.

Chairman STARK. Thank you. If you and Mr. Koplan could get together after these hearings and work out something that would be satisfactory to both of you, you would be of great service to this committee. Go ahead, Steve.

Mr. KOPLAN. Thank you, Mr. Chairman. I would like to just add a couple of comments. One, with regard to withholding, just briefly, I want to quote a statement made by the Treasury Department in the past, and that is that "information reporting can never replace withholding as a means of achieving satisfactory compliance."

All I want to say at this point about withholding is that it is not a new tax. All withholding does is effectuate compliance.

The point is that forms 1099 are not attached to income tax returns, and that is the problem, while forms W2 are. So if you look at the rate of compliance with a W2 form attached, there is no comparison to the situation with regard to 1099's, and that is why we are here talking about compliance. But withholding, I would emphasize, as you know, is not a new tax.

Mr. GUARINI. Mr. Chairman, may I just ask, if I could possibly, the panel we have before us as to their position on withholding, assuming whatever definition we have of an independent contractor. The Bar Association, I assume, is for withholding?

Mr. NOLAN. Mr. Guarini, the Bar Association hasn't taken a position on withholding, except in the limited circumstances where an incorrect identification number is furnished or none is furnished. I understand your question, however, also to ask for my personal position. Personally, I favor withholding as an individual. I have spent a great deal of time studying tax administration over the years, and I do not feel that withholding is much of a burden on employers. I have a secretary that I employ through my law firm, but I also employ a secretary personally. I file a simple form four times a year and pay the tax, and furnish a W2 to her at the end of the year. It is not a very great burden.

I feel personally that the question is really in the wrong framework. The question of withholding should not turn on common law test of employee versus independent contractor. It should turn on the degree of repetitive payments that are made by the payor to the payee. In other words, if the person is indeed an independent sales representative representing a number of companies, that is one situation. He is receiving payments from a number of companies, and he is in fact furnishing his own facilities for his work. Withholding may not be feasible.

But there are many people who simply deal with one payor, and are engaged in receiving repetitive payments from that person. I do not see any severe burden to withholding in those circumstances. Withholding clearly increases compliance substantially, as compared to information reporting. There is just no question about that. I used to be in the Treasury Department, spent a lot of time on this problem, and I can assure you that withholding is the only effective way of dealing with these situations where there are repetitive payments and it is justified. The only time it should be varied is when there is an undue burden, and I think that does exist when there are a number of payors involved.

Mr. **Guarini**. It helps our Tax Court.

Is the American Medical Association, Dr. Schenken, for withholding, as stated by Mr. Koplan?

Dr. **Schenken**. Is this withholding from independent contractors?

Mr. **Guarini**. That is right.

Dr. **Schenken**. The association has not taken a position. However, I feel that it is highly likely that they would view the activities of physicians and independent contractors with the risks and income fluctuations from month to month as to be incompatible with withholding, and I feel certain would take a position that the present system, with high compliance, and with quarterly payments, to be the appropriate way, so my guess is they would oppose withholding.

Mr. **Guarini**. Do you think an employee working for an ordinary industry should pay taxes in advance, whereas the person who is an independent contractor should pay at the end of the year, which gives him the advantage of using the money during the course of the year, when an average American citizen cannot have that advantage? Would that be your position?

Dr. **Schenken**. No. I didn't know that is the way it was. Most people pay quarterly.

Mr. **Guarini**. If they make above a certain sum of money. Mr. Hall.

Mr. **Hall**. If I tell all my members to incorporate, does that remove them from any of this involvement?

Mr. **Guarini**. We will ask the questions.

Mr. **Hall**. OK. I am curious. That is an easy solution.

We are definitely against withholding for independent contractors, specifically against it. It would be disastrous for our members.

Mr. **Guarini**. You are against withholding. Sir?

Mr. **Seifert**. We are against withholding. We are not surprised that the lawyers and the doctors are for withholding. But for the construction industry and those people who work with their hands, withholding would be a major problem; it would be devastating to make tax collectors of these people.

Mr. **Guarini**. Mr. Koplan.

Mr. **Koplan**. If I could make one brief additional comment, since Mr. Nolan referred to his past employment history. I spent 5 years prosecuting criminal tax cases for the Tax Division of the Justice Department, and I have strong personal feelings about withholding. I would just like to point out what Treasury said in 1979, when we were comparing information reporting versus withholding—and this is a direct quote from their testimony:

"Since the information necessary to implement a system for flat-rate withholding on payments to independent contractors must be obtained by payors to comply with the information reporting requirements of present law—the worker's name, address, and social security number—the additional costs associated with flat-rate withholding should not be significant, in fact, the payor's use of the withheld tax pending payment of these amounts to the Government should offset most, if not all, of these costs."

My point is simply that those people who are paying their taxes, if you poll them I am sure they don't care whether it is withheld or whether an information return is filed. The people who are concerned are the people who are not picked up by the IRS now. That is why we are asking for withholding. We feel very strongly it depends on how much money you want to raise. If you want to effect as much compliance as possible in this area—and I don't have to tell either of you gentlemen, because you voted for it in the last Congress in this subcommittee—then the way to go is withholding.

I would also like to say one other thing about the safe harbor. I listened to the questions that the Chairman and Mr. Duncan were asking of Treasury this morning, and it sounded to me as though the Treasury Department is taking into account the fact that there has been a moratorium.

They do not intend to rush into anything when the magic date expires at the end of this month, and perhaps it might be best for this subcommittee to let the date expire, and see what happens rather than rush to a complex safe harbor test, because as I look at our list of witnesses, and I listen to testimony today, it looks to me as though we are all the way back to where we were when we started in 1979.

As I read through the testimony of the American Medical Association, for example, when they testified in the Senate, there is a problem because there were a couple of private letter rulings. Those are requested by taxpayers. As I understand the private letter ruling, you are trying to find out before you do something whether you might have a problem with the IRS, so there is obviously a question in the taxpayer's mind as to whether he or she is doing the right thing.

Because of two letter rulings there is a whole series of amendments being suggested by the AMA, including a problem with the written contract requirement because some doctors operate on a handshake. I am not making it up. It is in here.

So I am just suggesting to the Chair that perhaps we ought to just let that date go by and see what happens. I would not suggest we wait on the compliance aspect of this legislation, but we would have no objection to letting the moratorium expire—rather than rush into a test, that puts us all the way back to——

Mr. DUNCAN. Mr. Chairman, I have a point of order. We are limiting the witnesses to 5 minutes.

Chairman STARK. The gentleman is quite correct.

Mr. DUNCAN. I think that rule should apply to Members of the House also.

Chairman **Stark**. Including the Chair?

Mr. **Duncan**. Including the Chair, if we are going to follow the 5-minute rule.

Chairman **Stark**. All right.

Mr. **Duncan**. I applaud you on the rule.

Chairman **Stark**. I applaud you for keeping us on the straight and narrow as you so often do, Mr. Duncan. I want to thank the witnesses, and I assure you that we will continue this discussion. Thank you very much for your participation.

Our next panel will include Mr. Richard DeVos, president of Amway Corp.; Mr. David Roberts, member of the executive committee of the National Association of Realtors; Monty Barber, vice chairman of the Board of Mary Kay Cosmetics, accompanied by Neil Offen, president of the Direct Selling Association, John Beyer, president, Robert R. Nathan Associates, and Arthur Rothkopf, counsel. There is room for everyone at the table.

Mr. DeVos, welcome and you may begin your remarks.

STATEMENT OF RICHARD DeVOS, PRESIDENT, AMWAY CORP.; ACCOMPANIED BY JOHN GARTLAND, DIRECTOR, WASHINGTON OFFICE

Mr. **DeVos**. Thank you, Mr. Chairman. I am president of the Amway Corp. With me is John Gartland, director of our Washington office. I am here today to speak to you concerning our dedication to participate as full and equal taxpayers from an industry that is as old as our country.

Our history is one to be proud of, independent entrepreneurs who depend on themselves and their services or products to achieve a product. Twenty-three years ago my partner and I started a direct selling company in our basements. Since that time Amway has grown to be one of the world's largest direct selling companies with estimated retail sales of more than $1.4 billion in 1981. Today there are more than 1 million Amway distributorships worldwide; 750,000 of those are in the United States delivering more than 350 different products to their customers' homes.

Some of these distributors are men, some women, but most are actually husband and wife teams making Amway direct selling very much a family business. Many have chosen to use the Amway business to supplement their primary income while others have made Amway their full-time career. To become an Amway distributor, initial cost is as little as $35, fully refundable. A person joins the world of Amway by being sponsored by a current Amway distributor.

One of the most important principles of our success has been keeping the system as simple as possible, thereby maintaining little paperwork for the distributors. This allows people to enter the Amway business with little or no business experience, yet to enjoy the freedom of having their own business and being their own boss. As I mentioned earlier, there are thousands of people within the world of Amway.

I do wish to state today that I find it somewhat disconcerting that we are gathered here to discuss and review alleged problems of compliance based on an IRS study of questionable data. The IRS survey was based on an examination of a number of returns filed by independent contractors that had already been plagued as disputed and were at that time under investigation. The former Assistant Secretary of the Treasury for Tax Policy, Mr. Don Luvick, stated the basis for the IRS study in his June 20, 1979 testimony before the Select Revenue Measures Committee of the House Ways and Means Committee.

The study focused on industries in which disputes between taxpayers and the IRS as to the employment status of workers have frequently arisen. To begin with, a list of the workers from all examined cases involving the employee independent issue were obtained. Conclusions drawn by the IRS from these disputed cases demonstrate only that not all of the disputed cases were the result of noncompliance. Their conclusions represent only the number of violations in the disputed class, a very small select group among the 4 million independent contractors in the United States.

The IRS has never conducted a study of all independent contractors. They have elected to pass judgment on millions of business people on the basis of faulty and misleading data. If we did that, some other agency would accuse us of deception and misleading promotion. We are back again 3 years later reviewing the issues raised in the same IRS study which has been proven faulty.

The IRS has presented no new study. We believe that the vast majority of Amway distributors are responsible citizens who are accounting for all their income on their tax returns and are claiming only those deductions which are permitted under the Internal Revenue Code. We are back once again to finding ways to punish those who are trying to improve themselves. In a time of unemployment we punish the self-employed.

We believe that this committee should begin to address the complexity of the present tax code. More and more Americans are having to rely upon tax advisers and preparers. Because of the complexity and ambiguity of the Tax Code, a small business person such as an Amway distributor cannot fully understand his tax liability and is therefore completely dependent upon a tax adviser. A simpler code would allow the American taxpayer to fully understand his responsibilities.

I would like at this time to address H.R. 6311, the Independent Contractor Tax Classification Compliance Act of 1982. We commend Congressmen Gephardt and Conable and cosponsors for a very comprehensive bill on the independent contractor issue. We strongly support this bill.

First, we support the safe harbor measure of H.R. 6311, which provides a statutory definition of "independent contractor." We agree that there is a need to retain the common law definition to protect the traditional independent contractor in our industry and to provide a guideline for new industries of the future. The safe harbor test and common law definition are consistent with the goals of our free enterprise system in which everyone has the opportunity to become an entrepreneur.

Next, I would like to address section 3 of H.R. 6311. The information reporting requirements for payment of remuneration for services and direct sales. I understand the complexities of trying to establish a reporting system for an industry in which every company differs from the others. But as I mentioned earlier, we are concerned with the complexities of the tax code itself.

We are also concerned about the additional cost and burden that will result from some of these measures with no additional revenue or useful or meaningful information being realized. Our concern does not relate to Amway itself but rather to the impact upon the hundreds of thousands of Amway distributors who will be affected.

H.R. 6311 would require that independent contractors report to the IRS annually the amount of gross sales over $5,000 made for resale purposes and the amount of remittances over $600. Reporting of gross sales in the case of Amway does not provide the IRS with the information needed to establish the exact amount of table income earned. For Amway distributors the product which is purchased either comes from the company or from an upline distributor, is used in one of three ways: for his own retail sales to customers; for sale at wholesale to the distributor's personally enlisted; and, three, for his personal and family use. As you can see from the foregoing reporting, gross sales is not really appropriate for the Amway system even though we understand under some direct sales programs such reporting may be the best method for gaining such information.

Amway independent distributors receive bonuses on their gross sales. The amount of such bonus payments provides a more realistic basis for taxable income than sales made. Therefore, Amway believes that lowering the $600 threshold for 1099 forms would provide the IRS with the kind of information useful to it.

We do support the alternative reporting provision of H.R. 6311. Let me state here that Amway Corp. already meets the alternative reporting requirements outlined in H.R. 6311, because Amway has for years distributed 1099 forms to each and every distributor with whom it deals directly; namely, our direct distributors.

Under the current law a 1099 form must be issued to those persons to whom we pay a bonus of $600 or more per year. In fact, we issue such a 1099 form to all direct distributors regardless of the amount of their bonuses, even down to $1. In addition, as required by the code, Amway files with the IRS a form 1096 which contains a summary of all the 1099 information. As you can see under the bill, we would already be doing more than is required of us.

We support lowering the threshold of the 1099 form to $50 or even less.

Further, we believe that the provision requiring distributors to file blank 1099 forms for all those who have received less than $50 in bonuses but who have purchased more than $1,500 worth of products in a year for resale is a most realistic figure, as compared to the Senate version of the bill in S. 2369. As you know, Senator Dole's bill on the Senate side requires that for those who receive less than $50 in bonus, but who purchase more than $50 worth of products, blank 1099 forms must be filed. The purchase of $50 worth of products is a very unrealistic threshold by which to determine whether someone is in a business to generate a profit.

As a matter of fact, since our product sales kit costs more than $50, anyone who purchased a sales kit would be covered by a 1099 form even though he conducted no business whatsoever.

Chairman **Stark**. Mr. DeVos, I am going to have to interrupt you and go on to Mr. Roberts. Your complete statement will appear in the record. I try to be as evenhanded as I can here so that we all get a chance. If you would like to extend your remarks at the conclusion of the hearing, you may.

[The prepared statement follows:]

Statement of Rich DeVos, President, Amway Corp.

Mr. Chairman and Members of the Subcommittee: My name is Rich DeVos. I am President of Amway Corporation. With me today is John Gartland, Director of the Amway Washington Office.

I am here today to speak to you concerning our dedication to participate as full and equal taxpayers from an industry that is as old as our country. Our history is one to be proud of—independent entrepreneurs who depend on themselves and their services or products to achieve a profit.

Twenty-three years ago, my partner Jay Van Andel and I started a direct selling company in our basements. Since that time, Amway has grown to be one of the world's largest direct selling companies with estimated retail sales of more than 1.4 billion dollars in 1981.

Amway products include items for home use and personal care, auto care, commercial and institutional use, as well as cosmetics, hosiery, cookware, and vitamins. Amway also makes available hundreds of famous brand-name items from clothing to rugs, from small appliances to watches, through our Amway Personal Shoppers Service.

Amway is headquartered in Ada, Michigan, and almost all Amway products are manufactured at Ada or by Nutrilite Products, Inc., our subsidiary at Lakeview and Buena Park, California, or in our recently acquired subsidiary, Statitrol, Inc., in Lakeview, Colorado. The company at present also distributes its products in 25 countries and territories. All Amway products are sold only through independent Amway distributors.

Through the Amway Sales and Marketing Plan, people from every walk of life have been able to establish successful, independent businesses in the direct selling industry. In a world that is growing more impersonal daily, personal selling—with its emphasis on quality products and dependable service—is experiencing an exciting rebirth.

Today, there are more than one million Amway distributorships worldwide. 750,000 of these are in the United States, delivering more than 350 different products right to their customers' homes. Some of these distributors are men, some women, but most are actually husband and wife teams, making Amway direct selling very much a family business. Many have chosen to use the Amway business to supplement their primary income, while others have made Amway their full-time career. To become an Amway distributor, the initial cost is as little as $35.00, which is fully refundable. A person joins the world of Amway by being sponsored by a current Amway distributor.

A strict code of ethics governs the business practices of every distributor. Amway distributors build their business through their own retail sales and by sponsoring, training, and motivating other distributors. Amway distributors succeed as sponsors only when *their* sponsored distributors succeed in selling products. Amway distributors do not pay for the right to sponsor others. There are no franchise fees or initial inventory requirements.

Once a distributor achieves a high level of sales volume through his own retail sales and the combined volume of those he has sponsored, the distributor becomes a Direct Distributor. As a Direct Distributor, he deals directly with the company and no longer with the distributor who sponsored him. Therefore, the majority of independent Amway distributors do *not* deal directly with Amway, and most likely conduct their businesses as parttime businesses.

One of the most important priciples of our success has been keeping the system as simple as possible—thereby maintaining little overhead and paperwork for the distributors. This allows people to enter the Amway business with little or no business experience, yet to enjoy the freedom of having their own business and being their own boss. As I mentioned earlier, there are thousands of people within the world of Amway. Each is an individual, yet all share a belief in the Free Enterprise System.

I do wish to state today that I find it somewhat disconcerting that we are gathered here to discuss and review alleged problems of compliance based on an IRS study of questionable data. The IRS "Survey" was based on the examination of a number or returns filed by independent contractors that had already been flagged as "disputed" and were at that time "under examination".

The former Assistant Secretary of the Treasury for Tax Policy, Mr. Donald C. Lubick, cited the basis for the IRS study in his June 20, 1979 testimony before the Select Revenue Measures Subcommittee of the House Ways and Means Committee: "The study focused specifically on industries in which disputes between taxpayers and the IRS as to the employment status of workers have frequently arisen. To begin with, a list of the workers from all open examination cases involving the employee-independent contractor issue was obtained."

The conclusions that were drawn by the IRS from these "disputed" cases demonstrate only that not all of the disputed cases were the result of non-compliance. Their conclusions represent only the number of violations in the disputed class, a very small, select group among the four million independent contractors in the United States. The IRS has never conducted a study of all independent contractors. They have elected to pass judgment on millions of business people on the basis of faulty and misleading data. If *we* did that, some other agency would accuse us of deception and misleading promotion.

We are back again, three years later, reviewing the issues raised in the same IRS study which has been proven faulty. The IRS has presented no new study.

We believe that the vast majority of Amway distributors are responsible citizens who are accounting for all of their income on their income tax returns and are claiming only those deductions which are premitted under the Internal Revenue Code.

We are back once again to finding ways to punish those who are trying to improve themselves. In a time of unemployment, we punish the self-employed.

We believe that this committee should begin to address the complexity of the present tax code. More and more, Americans are having to rely upon tax advisors and preparers. Because of the complexity and ambiguity of the tax code, a small business person such as an Amway distributor cannot fully understand his tax liabilities and is therefore completely dependent upon a tax asvisor. A simpler code would allow the American taxpayer to fully understand his responsibilities.

I would like at this time to address H.R. 6311—"The Independent Contractor Tax Classification and Compliance Act of 1982." We commend Congressmen Gephardt and Conable and the cosponsors for a very comprehensive bill on the independent contractor issue. We strongly support this bill.

First, we support the Safe Harbor Measure of H.R. 6311, which provides a statutory definition of "Independent Contractor." We agree that there is a need to retain the common law definition to protect the traditional independent contractor in our industry and to provide a guideline for new industries of the future. The "Safe Harbor" test and the common law definition are consistent with the goals of our free enterprise system, in which everyone has the opportunity to become an entrepreneur.

Next I would like to address Section 3 of H.R. 6311—The "Information Reporting Requirements For Payment Of Remuneration For Services And Direct Sales." I understand the complexities of trying to establish a reporting system for an industry in which every company differs from the other. But, as I mentioned earlier, we are concerned with the complexities of the Tax Code itself. We are also concerned about the additional cost and burden that will result from some of these measures, and from which no additional revenue or useful and meaningful information will be realized.

Our concern does not relate to Amway Corporation itself but rather to the impact upon the hundreds of thousands of Amway distributors who will be affected. As I mentioned earlier, Amway does not deal directly with the majority of Amway distributors. Therefore, it is our wish to keep the reporting requirements for distributors as simple as possible.

H.R. 6311 would require that independent contractors report to the IRS annually the amount of gross sales over $5,000 made for resale purposes and the amount of remittances over $600. Reporting of gross sales in the case of Amway does not provide the IRS with the information needed to establish the exact amount of taxable income earned. For Amway distributors, the product which is purchased either from the Company or from an upline distributor is used in one of three ways: (1) for his own retail sales to his customers; (2) for sale, at wholesale, to the distributors he has personally sponsored, which usually accounts for the majority of his sales; and (3) for his personal and family use.

As you can see from the foregoing, reporting gross sales is not really appropriate for the Amway system—even though we understand that, under some direct selling plans, such reporting may be the best method for gaining information for the IRS.

Amway independent distributors receive bonus payments on their gross sales. The amount of such bonus payments provides a more realistic basis for taxable income than sales made. Therefore, Amway believes that lowering the $600 threshold for 1099 forms would provide the IRS with the kind of information most useful to it.

We do support the alternative reporting provision of H. R. 6311. Let me state here that Amway Corporation already meets the alternative reporting requirements outlined in 6311 because Amway has for years distributed 1099 forms to each and every distributor with whom it does business directly—namely, our Direct Distributors. Under the current law, a 1099 form must be issued to those persons to whom we have paid a bonus of $600 or more per year. In fact, we issue such a 1099 form to all Direct Distributors, regardless of the amount of their bonuses, even down to $1.00. In addition, as required by the Code, Amway files with the IRS a form 1096, which contains a summary of all the 1099 information. As you can see, under the bill, we would already be doing more than is required of us.

We support lowering the threshold of the 1099 form to $50, or even less. Further, we believe that the provision requiring distributors to file blank 1099 forms for all those who have received less than $50 in bonuses but who have purchased more than $1500 worth of products in a year for resale is a most realistic figure, as compared to the Senate version of the bill in 2369. As you know, Sen. Dole's bill on the Senate side, S. 2369, requires that, for those who receive less than $50 in bonuses but who purchase more than $50 worth of products, blank 1099 forms must be filed. The purchase of $50 worth of products is a very unrealistic threshold by which to determine whether someone is in business to generate a profit. As a matter of fact, since our product sales kit costs more than $50, anyone who purchased one would be covered by a 1099 form even though he conducted no business whatsoever. Under our system, the distributor has no knowledge as to how much of the product, if any, was bought from him for resale. Therefore, we support the provision in H. R. 6311 for $1500 worth of products as the more realistic figure.

Another area of concern is the penalties section. Although we strongly support the need for increased penalties, we recommend that the committee review the severity of some of these penalties. For example, the penalties for the failure to provide a 1099 form to the payee and a copy to IRS would result in penalties equal to 30 percent of the amount of compensation which is subject to reporting. We submit that this is an unusually severe penalty, particularly in the case of first offenders. Perhaps you may wish to consider some type of fixed dollar limit for first offenders, as well as strengthening the "reasonable cause" provision. Is that all the IRS can do: get out the whip and threaten people? No wonder their gestapo-type tactics have brought fear and class hatred into the hearts of our citizens.

Now I would like to comment on H.R. 6300. If it is the wish of the committee that 6300 be the only tax bill reported out of the Ways and Means Committee this year, then I would strongly recommend that the committee substitute H.R. 6311, with its alternative reporting provisions, for Section 203 of H.R. 6300

Finally, I would like to recommend two additional measures which could be taken by this committee to help encourage the reporting of income by self-employed individuals: First, add a check-off box to the 1099 form, in which the taxpayer is to designate whether he has earned income from self-employment during the tax year. This feature would follow the precedent established by the IRS in other compliance areas. Second, require that a copy of the 1099 form be attached to the 1040 form in the same manner that a W-2 form is attached.

In conclusion, I would like to thank the Committee for this opportunity to discuss these issues which are important not only to Amway Corporation, but also to the 750,000 independent Amway distributorships nationwide. We fully recognize our responsibility, as American citizens, to pay our fair share of taxes, and will support your efforts to ensure that independent contractors pay their fair share of taxes.

I will be happy to answer any questions you may have. Thank you.

STATEMENT OF DAVID D. ROBERTS, MEMBER, EXECUTIVE COMMITTEE, NATIONAL ASSOCIATION OF REALTORS; ACCOMPANIED BY WILLIAM THURMAN

Mr. Roberts. Thank you, Mr. Chairman.

Chairman Stark. You can enter your full statement in the record. Please summarize your remarks.

Mr. Roberts. Yes, sir. Mr. Chairman and members of the committee, my name is David D. Roberts. I am a realtor from Mobile, Ala., and presently a member of the executive committee of the National Association of Realtors. I have with me Mr. Gilbert Thurm.

We welcome and appreciate this opportunity to present our views on H.R. 6311, which would provide legislative standards to help determine whether individuals are employees or independent contractors for Federal tax purposes. We urge the committee to favorably report this bill.

For the past 40 years, Mr. Chairman, the central controversy in the employment tax area has been the status of certain individuals as either employees or independent contractors. I happen to be president of my own real estate company in Mobile, Ala. We employ about 25 people, and for those employees we fully comply with all the local, State, and Federal regulations and reporting requirements that are applicable—and there are a great many as you know.

In addition to these employees, my little company has under contract 150 other persons who are independent contractor real estate salesmen and saleswomen who are diligently meeting their tax obligations. We thank the members of the committee and Congress in general for providing the needed interim relief from unjustified IRS attempts to reclassify these salespeople as employees. This important relief originally provided by section 530 of the Revenue Act of 1978 will expire at the end of June. That is why it is so important to focus now on long-term legislation.

The National Association of Realtors supports H.R. 6311 for providing reasonable long-term standards which establish an alternative method of determining whether an individual is an employee or independent contractor. The bill provides a safe harbor by giving certainty as to tax status to independent contractors who are able to meet the five strict requirements contained in the bill.

At the same time, by retaining the common law test, it will not foreclose independent contractor status to an individual who may not meet all five safe harbor provisions. This safe harbor approach is important because it would be virtually impossible to design one specific legislative proposal to clearly meet the standards for all the numerous occupations and industries affected by this issue.

H.R. 6311 would provide a measure of certainty in those industries where the IRS reclassification program has disrupted business relationships and threatened the very existence of the independent small business person. In addition to the safe harbor classification standards, the bill would also impose penalties for failure to file information returns with respect to remuneration paid to independent contractors.

H.R. 6311 would not create, with one limited exception, any new information reporting or recordkeeping requirements. Rather, it would impose stricter penalties for failing to comply with existing compliance provisions.

The National Association of Realtors supports the compliance provisions in H.R. 6311. Improved information reporting on payments to independent contractors would help assure voluntary tax compliance throughout the independent contractor sector of the economy.

We are pleased to note that some of our recommendations to increase compliance, a higher dollar penalty for the failure to file forms 1099 and requiring independent contractors to be given a copy of form 1099 by the service recipient, have already been enacted as part of last year's tax bill. The compliance provisions in H.R. 6311 would complete the job of insuring that everyone pays his or her fair share of tax.

Mr. Chairman, H.R. 6311 would go a long way toward providing business taxpayers with greater certainty in classifying workers for tax purposes while assuring tax compliance. We urge you to favorably report this bill. I would be pleased to respond to any questions the committee may have.

Chairman STARK. Thank you very much, Mr. Roberts.

[The prepared statement follows:]

STATEMENT OF DAVID D. ROBERTS, ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS

My name is David D. Roberts. I am a Realtor from Mobile, Alabama, and presently a member of the Executive Committee of the National Association of Realtors. I am accompanied by Gil Thurm, Vice President and Legislative Counsel of the Government Affairs division of the Association.

BACKGROUND

For over 40 years, the central controversy in the employment area has been the question of whether particular workers or classes of workers should be treated as employees or as self-employed independent contractors. The distinction is important under existing law because employees and their employers are subject to tax under the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA) (Sections 3101 and 3301 of the Internal Revenue Code), whereas independent contractors are subject to tax on self-employment income (SECA) imposed by Section 1401 of the Code. Also, compensation paid to employees is subject to income tax withholding under Section 3402 of the Code, whereas independent contractors make quarterly income tax payments on their own behalf. Further, self-employed persons can establish Keogh retirement plans, whereas employees may not (although they may be able to establish Individual Retirement Accounts). Thus, reclassification of an independent contractor as an employee can cause a retirement plan to become taxable in the current year.

It is also impotant to note that income and Social Security taxes are withheld from an employee based on his gross compensation, whereas an independent contractor pays these taxes based on his net earnings after expenses. The distinction is very important to many independent contractors, such as real estate salespeople, who incur significant expenses in the pursuit of their livelihood. Reclassifying real estate salespeople as employees and thereby basing these taxes on gross earnings causes problems regarding overwithholding of income taxes. The problem of overwithholding of income taxes arises, for example, in the case of a real estate salesperson with significant but fluctuating business expenses. While a taxpayer may claim additional personal exemptions on his employee withholdng statement to reduce the amount withheld from his gross income, it may be difficult, if not impossible, for a real estate salesperson to estimate the amount of his future business expenses and, thus, the proper number of additional exemptions to claim.

One of the major reasons for the attempt by the Internal Revenue Service to reclassify independent contractors as employees was to make its own administrative functions easier. Yet, the IRS was trying to make sweeping substantive changes in the law to ease these administrative duties. A reclassification of independent contractors as employees would produce little if any additional revenue. Revenue is not greatly increased because an independent contractor pays, on his own behalf, income and Social Security taxes corresponding to those whithheld and paid by an employer on behalf of his employees. (There may be some increase because of the difference between FICA and SECA taxes). Revenue may, in fact, be decreased because reclassification as an employee may cost the marginal worker his livelihood due to increased tax, administrative, and bookkeeping costs to the alleged employer.

The Treasury Department claimed in 1979, based on an Internal Revenue Service compliance study of dubious validity, that the present lack of withholding of income taxes on payments to independent contractors causes underreporting of income on tax returns. Yet, according to the IRS's own data, at least 96 percent of the compensation received by independent contractors in the real estate industry is reported on tax returns. This is higher than the average level of compliance found in the American economy. Further, the General Accounting Office (GAO), in its report to the Joint Committee on Taxation regarding the tax treatment of employees and self-employed persons (dated November 21, 1977), stated that "those taxpayers involved in employee self-employed redeterminations had generally paid their income and Social Security taxes." Moreover, GAO pointed out that the IRS failed to consider other possible administrative approaches to the problem of underreporting.

Nevertheless, in order to prevent the alleged underreporting of income by independent contractors, the Treasury Department proposed the initiation of a burdensome and ill-considered withholding scheme under which all real estate brokers would be required to withhold tax on commissions paid to independent contractors. At the same time, however, the Treasury Department proposed nothing to provide necessary and desirable clarification to the tax status of independent contractors in the real estate industry. Clarification of tax status has become necessary only over the last few years, and only because of the misapplication of the long established common law test by the IRS.

The history of the tax treatment of real estate salespeople as employees or independent contractors under the common law test goes back many years. In 1938, the IRS issued a Social Security Tax ruling, S.S.T. 346, 1938-2 C.B. 300, which concluded that a typical real estate broker did not retain sufficient right to control the salespeople to establish the relationship of employer and employee. Five years later, the IRS concluded that S.S.T. 346 was erroneous and published Mimeograph 5504, 1943 C.B. 1066, holding that real estate salespeople in general should be treated as employees rather than independent contractors.

The courts, however, refused to accept the new position of the Service that real estate salespeople should be treated as employees rather than independent contractors. The courts held, first in *Broderick* v. *Squire*, 163 F. 2d 980 (9th Cir. 1947), and then in the leading case of *Dimmitt-Rickhoff-Bayer Real Estate Co.* v. *Finnegan*, 179 F. 2d 882 (8th Cir. 1950), that real estate salespeople should be treated as independent contractors under the authority of the decision of the U.S. Supreme Court in *Harrison* v. *Grey Van Lines*, 331 U.S. 704 (1947). The result in *Dimmitt* was accepted by the Service in Mimeograph 6566, 1951-1 C.B. 108, which revoked Mimeograph 5504 and stated that real estate salespeople would not be treated as employees where the facts are substantially similar to those of Mimeograph 5504 or the *Dimmitt* case.

For a quarter of a century after the publication of Mimeograph 6566 in 1951, it remained in effect as the official position of the IRS. Then, as a result of the misapplication of the common law test of control and for reasons of administrative convenience, the IRS suddenly reversed this position and took the view that real estate salespeople are employees and not independent contractors. Revenue Ruling 76-136, 1976-1 C.B. 312, and Revenue Ruling 76-137, 1976-1 C.B. 313. These Revenue Rulings were subsequently revoked by Revenue Ruling 78-365, 1978-2 C.B. 254, as a result of Congressional interest in connection with the Revenue Act of 1978.

The IRS misapplied the common law test of control because it apparently adopted the view that the existence of one "controlling factor" in a business relationship requires a worker to be classified as an employee, contrary to the established rule that no single factor is controlling on the classification question. See Treasury Regulation Section 31.3121(d)-1(c).

The Treasury Department, through the IRS, took this approach because it apparently believed that it is more convenient to collect taxes under a withholding scheme than to perform its true function of enforcing the laws enacted by Congress. In order to impose this withholding burden, it was necessary to reclassify real estate salespeople as employees rather than independent contractors.

As a result of this action, the common law test of control, which has served us well over the course of many years, has been distorted and misapplied by a Federal regulatory agency for purposes of its own administrative convenience. The National Association of Realtors urges this Committee to give serious consideration to the enactment of reasonable legislative standards under which real estate salespeople and other independent contractors can be certain as to their status for employment tax purposes. The standards proposed in the Independent Contractor Tax Classification and Compliance Act of 1982, H.R. 6311, discussed below, are reasonable and will give certainty to brokers and to real estate salespeople as to their tax status.

THE INDEPENDENT CONTRACTOR TAX CLARIFICATION AND COMPLIANCE ACT OF 1982

The Independent Contractor Tax Status Clarification Act of 1982, H.R. 6311, introduced by Representatives Gephardt, Conable, Heftel, Hance, Bafalis, Vander Jagt, Frenzel, Duncan and Holland, would provide a set of five requirements that, if satisfied, would result in a worker being treated as an independent contractor. All five of the requirements must be met before a worker will be treated as an independent contractor under the act. If the worker is not able to satisfy all five requirements, his status will be determined under the common law test.

The five requirements listed in the Act for "safe harbor" treatment as an independent contractor are the following: (1) The worker must control the aggregate number of hours actually worked and substantially all the scheduling of the hours worked; (2) No principal place of business (if any) of the worker with respect to the service is provided by the service-recipient unless the worker pays such service-recipient a fair rental. For purposes of this test, no place of business provided an individual by a service-recipient shall be treated as a principal place of business with respect to the services if substantially all of the service is not performed at such place or any other place of business provided by the service-recipient; (3) The worker has a substantial investment of his services or risks income fluctuations with respect to his services; and (4) The services of the independent contractor must be performed pursuant to a written contract that spells out the individual's status as an independent contractor and the consequences and responsibilities of such status, and the person or company for whom the worker performs the services must file all required information returns (such as Form 1099).

Mr. Chairman, a reasonable interpretation of H.R. 6311 would give taxpayers certainty in this area while at the same time addressing the concerns of the Treasury Department and the Internal Revenue Service.

CONTROL OF HOURS WORKED

The act would require that the worker control his working hours in order to qualify for the "safe harbor." This test will be satisfied only if the worker has the right to control the total number of hours worked. Control of working hours is one of the critical factors in the common law test for classifying workers as either employees or independent contractors.

We should emphasize that the fact that an independent contractor performs services for only one person or company during the year has no bearing on this test. For example, real estate salespeople under state law in all 50 states may perform services for two or more brokers. This requirement does not affect the control of hours, and real estate salespeople could meet the test as long as they had the right to control the aggregate number of hours worked and substantially all of the scheduling of these hours.

PLACE OF BUSINESS

This requirement of the act takes into account the fact that, under the common law test, an independent contractor provides his own principal place of business or may have no one principal place of business. This requirement in the act also takes into account, however, the realities of doing business in a modern society. Thus, the act would allow the person for whom services are performed to provide the independent contractor with his principal place of business, but only if the worker pays rent therefor. This rent should be either a reasonable fixed amount paid by the independent contractor or a mutually agreed upon division of fees or commissions.

The place of business test in the act also recognizes that many individuals, real estate salespeople among them, simply should not be treated as having a principal place of business. Real estate salespeople do not perform their services at a single fixed location even though the brokers for whom they perform these services often provide desks for their use. Since real estate salespeople move from home to home and customer to customer, the Act would correctly treat them as having no principal place of business for purposes of this test.

INVESTMENT OR INCOME FLUCTUATION

The act would codify the common law provision that an independent contractor's income level is not fixed or guaranteed. A real estate salesperson may make sales presentations over a period of time and incur significant expenses and yet, if no sale was made, he would derive no income for his efforts. In fact, he would incur a loss.

It is the risk of income fluctuation that is the crux of this test. Actual income fluctuation may arise from a variety of factors having to do with the salesperson's skill and degree of effort. However, as long as the salesperson exposes himself to the risk that, despite all his efforts, he may generate no sales and therefore no income, this test would be satisfied.

This test may also be satisfied if the worker has a substantial investment in the assets used in connection with the services performed.

WRITTEN CONTRACT AND FILING OF REQUIRED RETURNS

The final "safe harbor" provision in the Act would require the worker and the person for whom the services are to be performed to enter into a written contract, prior to the performance of the services, clearly indicating that the worker is an independent contractor and his tax responsibilities as a result of that status. Further, all information returns must be filed by the person for whom services are performed.

This requirement is intended to ensure that workers are aware of the tax responsibilities arising from independent contractor status and are provided with all the information necessary to meet these responsibilities. This requirement also ensures that the IRS has all the information necessary to monitor the tax collection process.

COMPLIANCE

In addition to the safe harbor classification standards, the bill would also impose penalties for failure to file information returns with respect to remuneration paid to independent contractors. H.R. 6311 would not create, with one limited exception, any new information-reporting or record-keeping requirements. Rather, it would impose stricter penalties for failing to comply with existing compliance provisions.

The National Association of Realtors supports the compliance provisions in H.R. 6311. Improved information reporting on payments to independent contractors would help assure voluntary tax compliance throughout the independent contractor sector of the economy. We are pleased to note that some of our recommendations to increase compliance, a higher dollar penalty for the failure to file Forms 1099, and requiring independent contractors to be given a copy of a Form 1099 by the service-recipient, have already been enacted as part of last year's tax bill. The compliance provisions in H.R. 6311 would complete the job of ensuring that everyone pays his or her fair share of tax.

COMMENTS ON H.R. 6311

The five safe harbor classification standards set forth in the Act are very strict. The National Association of Realtors believes that the standards should be strict in order to prevent workers who should obviously be classified as employees from inadvertently being reclassified as independent contractors.

H.R. 6311 was not designed or intended to "reclassify" anyone as an independent contractor and we do not believe that any workers who are presently considered employees would become independent contractors under the Act. The act was, however, designed and intended to establish rules and provide certainty in those industries where the IRS's reclassification program has disrupted business relationships and threatened the very existence of the independent businessperson. The only individuals who may be reclassified as independent contractors under the Act are those individuals who, as a result of the coercion and heavyhandedness of past IRS reclassification efforts, were forced into employee status and are returning to their rightful place among the ranks of independent contractors.

There can also be no argument that, solely as a result of this act, individuals would suddenly deem it essential to refer to themselves as independent contractors. H.R 6311 does nothing more than codify the long-established independent contractor standards of the common law. Since we have not experienced massive switchovers under these long-established standards over a course of so many years, we do not believe we will have massive switchovers as a result of this act. In fact, given the strictness of the five requirements listed in the act, massive switchovers are simply not possible.

CONCLUSION

The National Association of Realtors urges this Committee to favorably report H.R. 6311. This bill would provide a measure of certainty in determining the classification of a worker as an employee or independent contractor. H.R. 6311 would provide this certainty while at the same time maintaining the freedom to enter into a business relationship as an employee or independent contractor.

We appreciate this opportunity to present our views on this matter of urgent concern. We will be happy to try to answer any questions the Committee may have. Thank you.

Chairman STARK. Mr. Barber.

STATEMENT OF MONTY BARBER, VICE CHAIRMAN OF THE BOARD, DIRECT SELLING ASSOCIATION (VICE PRESIDENT AND GENERAL COUNSEL, MARY KAY COSMETICS), ACCOMPANIED BY NEIL OFFEN, PRESIDENT; JOHN BEYER, PRESIDENT OF ROBERT R. NATHAN ASSOCIATES; AND ARTHUR J. ROTHKOPF, COUNSEL

Mr. BARBER. My name is Monty Barber. I am vice chairman of the board of directors of the Direct Selling Association (DSA) and also vice president and general counsel of Mary Kay Cosmetics, Inc. The gentlemen with me are identified on your witness sheet. We are grateful for this opportunity to testify in favor of the enactment of H.R. 6311, the bipartisan Independent Contractor Tax Classification and Compliance Act of 1982.

The Direct Selling Association is a trade association representing 120 direct selling companies and another 137 firms that supply goods or services to direct selling companies. There are virtually no barriers or requirements for entry. Direct sellers generally sell to their peers within their own communities, to their friends and neighbors. Each year they contact three out of every four homes in America. According to a Lou Harris study 8 percent of the homes in this Nation today include someone who will be a direct salesperson during the year, and an additional 15 percent of American homes have someone in the home who had previously acted as a direct salesperson.

The use of the independent contractor is fundamental to the structure of the direct selling industry. Industry firms have relied on this relationship for more than 100 years, long before enactment of the Internal Revenue Code or the Social Security Act. For tax purposes the Internal Revenue Code has long respected this status of independent contractors as determined under common law. Fortunately for the direct selling industry and its independent contractors, the IRS has had no success in attempting to reclassify direct sales people as employees, although its attempts caused at least two companies threatened with huge retroactive assessments to cease doing business.

Since the enactment of section 530 and through the period covered by the two extensions, DSA has encouraged the Congress to enact reasonable safe harbor standards for determining the status of independent contractors without imposition of withholding. While there are certain compliance provisions of H.R. 6311 which are quite burdensome on numerous direct selling companies we support the bill in order to resolve the issue on a substantive basis.

We believe H.R. 6311 is a constructive, realistic and responsible piece of legislation which while imposing significant new information reporting burdens solely on direct sellers and including more severe penalty provisions than under current law is acceptable to DSA. The direct selling industry believes those individuals engaged in direct selling have an excellent tax compliance record. Notwithstanding the absence of any credible objective data IRS officials continue to claim that independent contractor and direct selling tax compliance is poor.

The Treasury Department continues to rely on the discredited 1979 IRS study in concluding that noncompliance is high among independent contractors. We completely reject that conclusion and refer to Attachment 1 prepared by Robert R. Nathan Associates pointing out the fundamental flaws in the IRS study.

For example, even assuming that the results of the 1979 study were correct, which we don't accept, Robert R. Nathan Associates has estimates based on that study that 85 to 90 percent of the taxes owed by independent contractors and direct sellers were paid. Because of this compliance record we in the direct selling industry are deeply disturbed by the efforts of the IRS to link direct salespersons and the so-called underground economy or tax compliance gap. To associate in any way direct sales people as being a major factor in the IRS's estimate of $26 billion of unpaid taxes by self-employed persons is completely inaccurate.

In response to that concern Robert R. Nathan Associates has undertaken further analysis to determine total unpaid taxes for a recent year of all direct salespersons. The results of this analysis based on data for 1980 show potential unpaid taxes for all direct salespersons of only $35 million or less than $9 per salesperson. In fact, we believe this number overstates unpaid taxes.

DSA strongly supports enactment of the classification provisions of H.R. 6311. We believe Treasury concerns about the safe harbor in H.R. 6311 are misplaced. Treasury seems to be more concerned with whether withholding would be appropriate for those individuals covered by the safe harbor and less interested in whether the key elements of the traditional common law tests have been met.

Moreover the Treasury proposed test focuses unduly on requiring a substantial investment or risk of loss in qualifying. As an industry that has successfully litigated with the IRS under the common law we reject that formulation and believe the Treasury test would not treat certain traditional independent contractors as such and would discriminate unfairly against the small business person who is starting up with little capital.

The compliance provisions will be most burdensome in requiring an annual report to be filed by direct sellers reflecting sales of products for resale in the home to any buyer on a buy-sell, sale or deposit commission basis where the amount of sales for a particular buyer during the calendar year is $5,000 or more.

In the alternative, the bill would permit election by the direct selling company to furnish more information on remuneration by reducing the threshold amount from $600 to $50 and by furnishing certain information identifying those individuals purchasing goods for resale in excess of $1,500. Notwithstanding these severe reservations about adoption of specific new information reporting requirements solely for direct sellers, DSA supports the direct sales reporting requirements of H.R. 6311 in order to achieve a final resolution of the classification issue.

The new reporting system will be expensive and administratively disruptive to many of our companies. But we can support it provided the alternative approach in the bill is retained and the provision is included as part of a safe harbor classification bill along the lines of H.R. 6311. We strongly favor the safe harbor provisions. While there are compliance provisions that are quite burdensome, as I said, we are firmly in support of enactment of the legislation since it represents constructive and responsible legislation that will end the uncertainty in this area and permit the tax laws to be administered in a manner that would be beneficial both to Government and private industry.

We urge this subcommittee act promptly to report H.R. 6311 favorably.

Chairman STARK. Thank you, Mr. Barber.

[The prepared statement follows:]

STATEMENT OF THE DIRECT SELLING ASSOCIATION

Mr. Chairman and Members of the Subcommittee: My name is Monty Barber. I am Vice Chairman of the Board of Directors of the Direct Selling Association (DSA) and Vice President and General Counsel of Mary Kay Cosmetics, Inc. With me today are Neil H. Offen, president of DSA, John C. Beyer, president of Robert R. Nathan Associates, Inc. (RRNA), and Arthur J. Rothkopf of the Washington law firm of Hogan & Hartson, who serves as tax counsel to the Association.

We are grateful for this opportunity to testify in favor of the enactment of H.R. 6311, the bipartisan Independent Contractor Tax Classification and Compliance Act of 1982.

THE DIRECT SELLING INDUSTRY

The Direct Selling Association is a trade association representing 120 direct selling companies and another 137 firms that supply goods or services to direct selling companies. In addition, more than 4 million independent salespeople who market the products of direct selling companies are affiliate members of DSA. Direct selling is a method of distribution through which products and services are marketed directly to consumers in their homes. Companies within the industry market a wide variety of consumer products and services: household cleaning products, cosmetics and other personal care products, jewelry, cookware and other housewares, educational materials, home improvement products and services, food, vitamins, and so forth. The majority of companies within the industry qualify as small businesses. In 1980, total industry sales approximated $7.5 billion at retail.

But more important than the characteristics of the direct selling companies are the characteristics of the individual entrepreneurs who do business with the companies. There are virtually no barriers or requirements for entry into direct selling. It is a field open to any American. It provides flexible income-earning opportunities. For example, there are no demands that direct salespeople spend a given number of hours or sell at any particular time. For those reasons, direct selling has wide appeal among women who have significant family responsibilities.

The flexibility of the industry and ease of entry also attract substantial numbers of minorities, the disabled, and the elderly. In any year, over four million people engage in direct selling in the United States, with at least two million active in the business at any given time. Eighty percent of direct salespeople are women. Further, during any year, more than 600,000 are minorities, 200,000 are over 65, and 400,000 have disabilities. The overwhelming majority of these salespeople—89 percent—work part-time and nearly two-thirds work less than ten hours per week.

For most direct salespeople, selling is not seen as a "job" but as an additional earning opportunity—a way for many people with modest or fixed incomes to supplement their earnings and make ends meet. Many direct salespeople sell intermittently and for different companies (sometimes for more than one company at the same time), establishing short-term specific earning goals and then terminating their sales activity when the goals are met. This way of doing business, which is foreign to an employer-employee relationship, helps to account for the industry's high turnover rate, which is in excess of 100 percent each year.

Simply stated, direct selling is an ideal way for some of these people to earn extra money without past business experience, without substantial capital, and without having to make a full-time commitment to an employer. Direct selling is also an excellent way for individuals to establish full-time career opportunities after first working on a part-time basis. Those who devote more time will obviously earn more from direct selling. Thus, 10 percent of those engaged in directy selling earn 63 percent of total income.

THE ROLE OF INDEPENDENT CONTRACTORS IN DIRECT SELLING

The people who sell the products of direct selling companies have traditionally operated as independent contractors for reasons that are fundamental to the structure of the industry. The motivation of direct salespeople is directly related to the fact that they in effect have their own business: they control the hours they work, they conduct business away from any office or other fixed location, they keep their own records and books, frequently they maintain their own inventories, and they pay their own expenses. Direct salespeople are, by any objective assessment, independent businesspeople and operate in the same fashion as retailers throughout the country, except for the fact that they bring their products to the home of the consumer and do not operate from any fixed retail location. They do not perceive themselves as employees, nor do they wish to be so treated. They generally sell to their peers within their own communities, to their friends and neighbors. Each year, they contact three out of every four homes in America. According to a Lou Harris study, 8 percent of the homes in this nation today include someone who will be a direct salesperson during the year, and an additional 15 percent of America's homes have someone in the home who had previously acted as a direct salespersons.

The independence of the operations of direct salespeople is a crucial factor in the decisions of individuals to become direct salespeople. Our Lou Harris study of direct salespeople found that they rate their own independence, being their own bosses, as the most important element of their sales work, even more important than the specific income they received, which was a close second. This person who sees himself or herself as in independent businessperson is the heart of the direct sales industry.

The success of direct selling companies is a function of the size and capability of their sales forces. Each company strives to expand its sales force, and competition among direct sales companies for salespeople is keen. Consequently, direct selling companies minimize their additional fixed costs for increasing the size of their sales force and create wide opportunities for marginal workers to enter direct selling. The increased size of the sales force and the minimal administrative costs associated with adding salespersons are key economic factors in the growth of direct selling. The independent contractor relationship is crucial to minimizing personnel costs and maximizing opportunities available. The relationships between direct selling companies and their salespeople are also extremely sensitive, especially with new recruits. Experience within the industry demonstrates that changing any aspects of these relationships or imposing additional administrative or other burdens will produce severe adverse consequences to the industry.

The use of independent contractors is fundamental to the structure of the direct selling industry. Industry firms have relied on this relationship for more than 100 years, long before enactment of the Internal Revenue Code or the Social Security Act. For tax purposes the Internal Revenue Code has long respected this status of independent contractors as determined under the common law. Traditionally, in the direct selling industry the tests for that status imposed by the common law were clearly met, and direct salespeople were treated as independent contractors for tax purposes without substantial dispute.

However, during the 1970's the Internal Revenue Service adopted an increasingly aggressive and unjustified audit position of challenging the independent contractor status of a broad group of individuals, including some direct salespeople. The most prominent example, and the test case, in the direct selling industry involved Queen's-Way to Fashion, Inc., a direct selling company subsequently renamed Aparacor, Inc. The IRS challenge culminated in a decision by the U.S. Court of Claims (*Aparacor, Inc.* v. *United States*, 556 F.2d 1004, 1977). In that case the Court sustained the independent contractor status of the direct salespeople and stated that the IRS assessment "represents a radical departure from the traditional common law concept" (556 F.2d at 1012). While the company won the case, it was a costly victory; the company's growth and development were set back for years pending the outcome of the litigation.[1]

The unjustified attacks on the independent contractor status of direct salespeople illustrated in the *Aparacor, Inc.* case cannot only immobilize a company's operations, but also create huge retroactive assessments which can jeopardize the financial well-being of a direct selling company. In challenging a company's treatment of individuals as independent contractors, the IRS assesses the company for the full amount of income taxes which it asserts should have been withheld were all its independent contractors treated as employees, plus both the employee and employer share of FICA taxes and FUTA taxes. These amounts have been assessed in many cases even though the individual treated as an independent contractor has in fact paid the full amount of income taxes and self-employment taxes which he or she owed. In these cases, the IRS assessments have resulted in double tax, since income taxes for the same individual would both be paid by that individual and the company, and similarly both FICA and self-employment taxes would be paid. In order for the company to reduce this double tax, it has the burden of locating its reclassified independent contractors and obtaining from them information regarding their tax payments, which is particularly difficult for direct selling companies with their high turnover rates. The IRS refuses to assist the companies in this regard.

---

[1] A second case, involving Beeline Fashions, Inc., was subsequently settled to the company's satisfaction, permitting the company to continue its previously established independent contractor treatment of its salespeople.

Fortunately for the direct selling industry and its independent contractors, the IRS has had no success in attempting to reclassify direct salespeople as employees. However, continued IRS excesses in seeking to reclassify independent contractors generally led to the enactment of § 530 of the Revenue Act of 1978, which placed a moratorium on IRS enforcement and regulatory activities in the independent contractor area, pending action by Congress.

Since the enactment of § 530 and through the period covered by the two extensions, DSA has encouraged the Congress to enact reasonable safe-harbor standards for determining the status of independent contractors. Direct selling companies believe that the enactment of a reasonable safe-harbor, provided that the common law is available in the event the safe-harbor is not satisfied, would be a major step forward in helping to resolve the expensive and prolonged controversies that have arisen over who is or is not an independent contractor.

DSA wishes to commend Congressmen Gephardt and Conable for their efforts in developing legislation to provide a responsible safe harbor classification rule for determining independent contractor status without imposition of a draconian, and in the case of direct sellers, unworkable withholding program. DSA has long held to the view that it is in the national interest to develop a permanent solution to the classification issue for independent contractors and that such a solution in the form of a safe-harbor bill should be enacted as part of legislation which did not resort to withholding on independent contractors. While there are certain compliance provisions of H.R. 6311 which are quite burdensome on numerous direct selling companies,we are prepared to support the bill in order to resolve the issue on a substantive basis. We believe that H.R. 6311 is a constructive, realistic and responsible piece of legislation which, while imposing significant new information reporting burdens solely on direct sellers and including more severe penalty provisions than under current law, is acceptable to DSA. We urge that Congress speedily enact H.R. 6311.

COMPLIANCE OF DIRECT SELLERS

The direct selling industry believes that those individuals engaged in direct selling have an excellent tax compliance record. On both an ethical as well as legal basis, direct salespeople, like other self-employed taxpayers, should pay their taxes and report proper business deductions, and we are convinced that they do so.

Our industry has had a long history of cooperation with the Internal Revenue Service to encourage voluntary compliance on the part of direct selling companies and their salespeople. Over the past ten years, many meetings have been held with Internal Revenue Service personnel, almost invariably at the instance of DSA, to determine additional ways in which the compliance levels of those engaged in direct selling could be improved. These efforts on the part of the industry have not gone unnoticed, as reflected in a letter, dated October 17, 1977, from the Office of the Commissioner of the Internal Revenue Service, which acknowledged "a history of concern and cooperation on the part of the Direct Selling Association with the Internal Revenue Service in our cooperative efforts to promote voluntary compliance." These efforts over a period of many years have borne fruit in an extensive educational program engaged in by direct selling companies to assist and encourage their salespeople to fully and accurately report their income and deductions attributable to direct selling. DSA's member companies have an excellent record of distributing to their salespeople detailed information on a frequent basis that explains to the salespeople their federal income and employment tax responsibilities. This written material demonstrates a real concern on the part of the companies for tax compliance, which we believe is reflected in an excellent compliance record on the part of those who are engaged in direct selling.

In 1979, the Internal Revenue Service prepared a study which purported to show that independent contractors in general, including direct sellers, had low levels of tax compliance. Robert R. Nathan appeared before this subcommittee in 1979 and presented a detailed assessment prepared by his firm which demonstrated the fundamentally flawed manner in which this IRS study was conducted. His conclusion then, as it remains today, was that the IRS study was so deficient in design that no meaningful conclusions should be drawn concerning compliance of independent contractors generally and of direct salespersons in particular. It should be noted that it is highly doubtful that the direct selling industry was appropriately represented in the study, and, in fact, no member company of DSA is aware of any of their direct salespersons who were incorporated in the study. (See attachment 1.)

Notwithstanding the absence of any credible, objective data, IRS officials continue to claim that independent contractor and direct selling tax compliance is poor. Moreover, in recent testimony before the Senate Finance Committee on April 26, the Treasury Department continued to rely on the discredited 1979 IRS study in concluding that noncompliance is high among independent contractors. We completely reject that conclusion. For example, even assuming for purposes of analysis that the results of the 1979 IRS study were correct (which we do not accept), the Nathan firm has estimated (based on that IRS study) that 85–90 percent of the taxes owed by independent contractors and direct sellers were paid. The accuracy of this estimate was confirmed in Assistant Secretary Chapoton's testimony before the Senate Finance Committee on April 26 (at p. 2).

Because of this compliance record, I and others in the direct selling industry are deeply disturbed by the effort of the IRS to link direct salespersons and the so-called "underground economy" or the "tax compliance gap." To associate in any way direct salespersons as being a major factor in the IRS's estimate of $26 billion of unpaid taxes by self-employed persons is completely inappropriate. In response to our concern, Robert R. Nathan Associates has undertaken further analysis to determine total unpaid taxes for a recent year for all direct salespersons. The results of this analysis, based on data for 1980, show potential unpaid taxes for all direct salespersons of only $35 million (or less than $9 per salesperson), and in fact, we believe that this number overstates unpaid taxes. (See Attachment 2.) Given the size of the industry, the number of people engaged in direct selling and net income of all direct salespeople of $1.3 billion, this possible unpaid tax figure is truly a nominal one. Moreover, through the new compliance measures in H.R. 6311 and industry initiatives in taxpayer education, it is expected that this nominal figure will be reduced even further in the future.

This subcommittee held a hearing on April 19 inquiring into the efforts of certain individuals engaged in direct selling to convert nondeductible personal expenses into deductible business expenses. Twenty instances of such activities were presented to the subcommittee based upon audits in a single IRS district. The Internal Revenue Service has recently publicized audits which it is conducting of 1334 direct sellers living in the Baltimore district to determine if excessive business deductions were claimed. While DSA believes it is appropriate for IRS to pursue its audit objectives, it is totally inappropriate to draw any conclusions about excessive deductions by direct sellers. These audits are not a sample (as IRS has agreed) but rather are presumably selected on the basis of a pre-screening for business losses, as would be done in the audit process for self-employed persons. Moreover, it should be emphasized that no evidence has been presented—at the April 19 hearing or elsewhere—to suggest that any direct selling company encouraged its distributors to claim excessive deductions. In fact, the contrary is true. The direct selling company that appeared before the subcommittee demonstrated that it took prompt corrective action to advise its distributors of the proper treatment of tax deductions, once it learned that improper tax advice was being disseminated by tax preparers to some of its distributors.

DSA recognizes that there may be individuals engaged in direct selling, as well as other occupations, who overstate their tax deductions. DSA disowns such activities and condemns the actions of those self-employed individuals and tax return preparers who have sought to convert non-deductible personal expenses into deductible business expenses. The incidence of improper tax deductions among all self-employed persons can only be reduced by improved IRS audit capability and initiatives by the affected industries in educational efforts. DSA has consistently supported both efforts. Direct selling is not a tax shelter; it is a means for individuals to earn additional income through the sale of products and to develop their own businesses.

The well-being and viability of DSA member firms is totally dependent upon sale of their products to the ultimate consumer.

It is critical to keep in mind, however, that isolated instances of improper tax deductions taken by independent contractors have no bearing on the important classification and other tax issues addressed in H.R. 6311. Consideration of H.R. 6311 should proceed forward at the earliest possible time so that the controversy surrounding the classification of independent contractors can be resolved.

H.R. 6311

Safe-Harbor provisions.—The Direct Selling Association strongly supports the enactment of the classification provisions of H.R. 6311. It is our belief that this bill deals with the independent contractor classification question in a judicious and reasonable manner by establishing a safe-harbor to provide certainty for the Government, companies utilizing independent contractors and individual independent contractors. The legislation was carefully drafted to permit traditional independent contractors to continue in that status without fear of harassment from the Internal Revenue Service. Those industries that are unable to meet the safe-harbor standards of this legislation would continue to be judged under the traditional common law standards. The legislation would have the effect of eliminating a great deal of the controversy that has characterized this issue prior to the enactment of § 530 in 1978.

The bill would require that persons seeking to take advantage of the safe-harbor meet both a control-of-hours test and a place-of-business test, and in addition, satisfy either an investment or income fluctuation test. These factors are the key elements of the traditional common law requirements for independent contractor status, and therefore, appropriately form the basis for a safe-harbor standard.

We believe that the concerns about the safe harbor in H.R. 6311 reflected by the Treasury Department in its April 26 Senate Finance Committee testimony are misplaced. Treasury seems to be more concerned with whether withholding would be appropriate on those individuals covered by the safe harbor, and less interested in whether the key elements of the traditional common law test have been met. Moreover, the Treasury-proposed test focuses unduly on requiring a substantial investment or risk of loss in qualifying as an independent contractor under the safe harbor. As an industry that has successfully litigated with the IRS under the common law, we reject that formulation and believe that the Treasury approach would not treat certain traditional independent contractors as such, and discriminate unfairly against the small business person who is starting up with little capital.

H.R. 6311 also requires that a written contract be entered into between the independent contractor and the company for whom the services are performed, and that the independent contractor be furnished a written notice of his or her tax responsibilities at the time the contract is executed. Moreover, in order for the safe-harbor test to apply, all required information returns would have to be filed. We believe that this legislation represents a fair and workable effort to prescribe the most significant standards in determining whether an individual is an independent contractor, and accordingly, we urge its enactment.

We must emphasize, however, that the support of DSA for the classification provisions of H.R. 6311 is based on its safe-harbor approach. DSA would oppose this or any other bill which would replace the common law with a specified statutory test or presumption. By preserving the common law means for attaining independent contractor status, the bill retains the flexibility that the common law provides—so that new companies and new ways of doing business can be accommodated as they arise. This flexibility is, in our view, crucial to any status determination for tax purposes and is important to the well-being of our economy.

The suggestion has been made that it might be advisable to let the moratorium lapse and permit the IRS to promulgate regulations defining who is and who is not an independent contractor. We find such an approach to be completely unacceptable. DSA believes that it is only the Congress that can objectively formulate the proper classification test. The IRS has demonstrated, based on its dismal record of overreaching and ignoring existing standards, that it does not have the perspective to handle such a project in an objective manner and is more interested in effecting withholding on all independent contractors. Unfortunately, we have simply lost faith in the ability of the IRS to view this issue fairly and, therefore, would oppose any effort to resolve the issue by giving the IRS broad regulatory authority.

We thus support the classification provisions of H.R. 6311 because it permits those companies desiring certainty against IRS challenge to have that certainty if its safe-harbor requirements are met. At the same time, the bill avoids forcing companies and independent business people into arbitrary and restrictive methods of operation in order to remain independent contractors. Moreover, the legislation will free IRS personnel from pursuing classification issues and permit them to focus their attentions on non-filers and those filing fraudulent returns.

Compliance provisions.—H.R. 6311 contains various provisions designed to improve tax compliance among independent contractors. While we have concerns about certain of these provisions, we are most encouraged by the fact that they seek to deal with the subject of improved tax compliance without resorting to the requirement of withholding on independent contractors, except in the limited case in which an independent contractor fails to furnish a taxpayer identification number or furnishes an incorrect number. The Treasury has stated that many information returns filed by payors do not include any taxpayer identification number or include an incorrect number. Often there is little the payor can do about this. We recognize that the failure to include correct taxpayer identification numbers on Forms 1099 makes it extremely difficult, if not impossible, for the IRS information reporting system to operate properly. Therefore, while we have concern about the imposition of withholding on independent contractors in any circumstance, we do not object to the withholding provisions on remuneration paid of H.R. 6311 in those instances in which either no taxpayer identification number or an incorrect number is provided, and notice is given to the payee with the opportunity to supply a proper identification number

H.R. 6311 provides for much stricter penalties than under current law for the failure to provide to the Internal Revenue Service information returns on payments to independent contractors and for the failure to provide copies of such returns to the independent contractor. DSA has consistently supported increased penalties for the failure to provide Forms 1099 where required.

However, we are concerned that these penalty provisions may be excessive in some circumstances. They could result in a penalty equal to 30 percent of the amount of remuneration subject to reporting requirements, even in the case of a first offense. In light of the vagueness of the "reasonable cause" exception, we suggest that consideration be given to placing a dollar limit on a first offense for violating these information reporting requirements. We also believe that the penalty provisions applicable to information returns on commissions and the penalty provisions applicable to the new direct seller buy-sell information returns could produce penalties in excess of 30 percent of the remuneration arising from the same transactions. We believe that this is an unintended, overly harsh result and urge that it be clarified accordingly. Finally, we suggest that consideration be given to limiting the penalty provisions' applicability to non-cash compensation where legitimate disputes may arise over value, but where the potential for extremely severe penalties exists.

The compliance provision of H.R. 6311 will be most burdensome in requiring that an annual report be filed by direct sellers reflecting sales of products for resale in the home to any buyer on a buy-sell or deposit-commission basis, where the amount of sales to a particular buyer during the calendar year is $5,000 or more. This reporting requirement would be in addition to the existing requirement that information returns be filed on remuneration paid in excess of $600 during the calendar year. In the alternative, the bill would permit an election by a direct selling company to furnish more information on commissions, sales bonuses and other remuneration paid (by reducing the threshold for reporting such remuneration from $600 to $50) and by furnishing certain information identifying those individuals purchasing goods for resale in excess of $1500 during the year.

DSA has in the past strongly opposed the enactment of reporting provisions that would require companies operating on a buy-sell basis to furnish gross sales data on the grounds that the added burden and costs resulting from this additional information reporting would not be justified by any additional revenue that might be achieved. However, notwithstanding the severe reservations which DSA has about the adoption of specific new information reporting requirements solely on direct sellers, DSA supports the direct sales reporting requirements of H.R. 6311 in order to achieve a final resolution of the classification issue. We wish to emphasize that we are willing to support these new reporting requirements in deference to the good faith efforts of Congressmen Gephardt and Conable to find an overall solution to the complex problems inherent in the independent contractor issue.

We should note that to some direct selling companies the gross sales reporting method of the bill would be preferable because of the substantial burden of reporting renumeration at the $50 level. Other companies, because of their structure, would prefer the reduced Form 1099 reporting alternative. Maintaining this option is crucial to our support of this legislation, in the light to the huge volume of transactions in our industry, the fact that 90 percent of direct salespeople work part-time, that two-thirds work less than 10 hours a week, and that some work only a few weeks during the year. In summary, the new reporting system will be expensive and administratively disruptive to many of our companies, but we can support it provided that (1) the alternative approach of the bill is retained and (2) the provision is included as part of a safe-harbor classification bill along the lines of H.R. 6311.

H.R. 5729 AND H.R. 4531

H.R. 5729 is a safe harbor classification bill introduced earlier this year by Congressman Gephardt. DSA favored enactment of H.R. 5729 since it was identical to legislation introduced by Congressman Gephardt in the previous Congress which DSA supported.

H.R. 4531 was introduced by Congressman Conable and developed certain refinements in the safe-harbor provisions of the Gephardt bill.

Since Congressmen Gephardt and Conable have jointly sponsored H.R. 6311, DSA favors the enactment of that legislation as the legislation which provides the most comprehensive and responsible treatment of the classification and compliance issues.

H.R. 5867

Safe-Harbor Provisions.—While it is the intention of H.R. 5867 (based on H.R. 5460 in the last Congress) to specifically treat direct sellers as independent contractors under that legislation, DSA does not support enactment of the safe-harbor provisions of H.R. 5867, since it does not favor legislation that would treat direct sellers as independent contractors simply because they are direct sellers. Rather, we believe that Congress should legislate safe-harbor standards according to the principles of H.R. 6311.

However, if Congress were to consider seriously enacting safe-harbor legislation such as that appearing in H.R. 5867, it should be pointed out that the drafting of the provision dealing with direct sales, which was not discussed in advance with DSA or its members, failed to cover adequately many direct sellers. Consequently, in order to meet its objective, clause (2)(C)(iii) would have to be modified to read as follows: "(iii) engaged in or involved in the development of the sale of (or the solicitation for sales of) products of a supplier (including any separate unit of a trade or business within the meaning of § 3121(a)(1)), most of the products of which are consumer products ultimately sold by direct sales made or solicited in the home."

The foregoing technical changes in the bill would have the effect of clarifying that distributors in multi-level operations qualify as direct sellers under the exemption since they do not themselves sell all of their products directly to consumers. The changes would also make clear that commission direct sellers who solicit and obtain orders would qualify for the exemption, and that amounts received as sales overrides would also qualify. In addition, the proposed change in language would make clear that the term "supplier" includes the concept of a separate unit as defined in § 3121(a)(1).

Withholding.—DSA strenuously opposes the withholding provisions of H.R. 5867, even though an exemption is provided in that legislation for those direct sellers who operate on a buy-sell or commission-deposit basis. The Direct Selling Association is fundamentally opposed to the concept of withholding on independent contractors and would oppose any legislation which incorporated such a provision. Furthermore, the proposed exemption would not cover more than 400,000 commission direct salespeople many of whom compete directly with buy-sell and commission-deposit salespeople. The added costs of doing business and the negative impact that withholding would entail for the commission salespeople and their companies would place them at a severe and unfair competitive disadvantage.

In the testimony of DSA and Robert R. Nathan in July, 1979, before this subcommittee, detailed statements were submitted setting forth the economic and other arguments against imposing withholding on the direct selling industry. In essence, the benefits in additional revenue to the Government from direct salespeople would be less than $30 million, and probably less than $20 million. In contrast, the economic consequences, both direct and indirect, of such withholding to the direct selling industry would be substantially greater than any potential revenue gain. Most significantly, DSA and its millions of independent contractors regard withholding as a badge of employment status which we reject.

Reporting of purchased goods by direct sellers.—DSA has consistently opposed the enactment of that provision of H.R. 5867 that calls for information reporting by any direct selling company operating on a buy-sell or deposit-commission basis with respect to each individual to whom the company sells, in one year, $3,000 or more of products for resale to consumers in the home. DSA believes that its member companies have an excellent compliance record, and that the added burden and costs resulting from this new information reporting return will not be justified by any additional revenue that might be achieved. Nonetheless, for the reasons set forth above, DSA is willing to support the alternative reporting provisions of H.R. 6311 as part of an overall resulution of the classification and related issues. The direct selling industry is prepared to accept the stringent administrative and paperwork burdens of H.R. 6311, which it regards as unfair and unnecessary, in order to put the independent contractor controversy to rest on a permanent basis.

PROCEDURAL ISSUES

In the press release announcing these hearings, comment was invited on the procedural problems incurred by taxpayers when they are the subject of IRS reclassification actions. While enactment of the safe-harbor provisions of H.R. 6311 will limit the number of classification controversies, they will still arise and DSA has long believed that reform in this area is overdue. The severe financial problems incurred by DSA members in litigating with the IRS on classification questions before the moratorium was enacted demonstrates the clear need for procedural change.

We urge that the Subcommittee give consideration to the adoption of a rule that limits considerably the amount that may be claimed by the IRS in an employment controversy, provided that a reasonable basis for the classification existed. We also believe that there should be taxpayer access to the Tax Court or some other form of judicial relief that does not require the disputed taxes or a large bond to be posted as a pre-condition to litigation.

We know that the Committee staff has been focusing on these important procedural questions and we would be pleased to give our more detailed views on these issues to the staff.

CONCLUSION

As a result of the overreaching of the Internal Revenue Service in the area of independent contractors, taxpayers have been in a state of uncertainty for several years. DSA believes that the time has come to end the moratorium and for permanent legislation to be enacted determining who is and who is not an independent contractor. If Congress fails to enact substantive classification legislation by June 30, we urge that the § 530 moratorium be extended until such time as substantive legislation is enacted.

We strongly favor the safe-harbor provisions of H.R. 6311. While there are compliance provisions in H.R. 6311 that are quite burdensome on our industry, we are firmly in support of the enactment of the legislation since it represents constructive and responsible legislation that will end the uncertainty in this area and permit the tax laws to be administered in a manner that will be beneficial both to Government and private industry.

We urge that this Subcommittee act promptly to report H.R. 6311 favorably.

ATTACHMENT 1.—DEFECTS IN THE IRS COMPLIANCE STUDY

The Treasury proposal to extend tax withholding to independent contractors is based on an IRS compliance study of 5,152 individuals which concludes that tax compliance for independent contractors is poor. This study and the conclusions drawn from it are too seriously flawed to serve as the basis for such a fundamental tax change.

The IRS failed to estimate compliance rates correctly.—The IRS failed to compare taxes paid on independent contractor income to total taxes owed. Using the IRS's own data for the 5,152 workers in the study, it is estimated that 90 percent of the taxes owed on this income have been paid. Failure to measure this most basic and meaningful compliance rate is a serious flaw in the IRS study.

The IRS failed to utilize net income as the most appropriate measure for calculating compliance rates, resulting in an overstatement of noncompliance.

The IRS failed to include in the compliance estimates individuals whose total income was below the level of that required for filing returns. This resulted in further overstatement of noncompliance.

The IRS failed to measure tax compliance where information returns (Forms 1099) are furnished to independent contractors. Such a correlation would have indicated whether better information reporting would lead to increased compliance.

The IRS included as noncompliers a large number of workers (estimated to be almost 20 percent of the sample) whom the IRS found had no tax liability as independent contractors.

Even the IRS data demonstrate that additional revenue from tax withholding will be small.—The Treasury has stated that withholding and strengthened information reporting would raise the tax compliance rate to approximately 90 percent, but the IRS study supports the conclusion that the tax compliance rate for independent contractors is already at that level.

The IRS study shows that additional revenue would come from a very small proportion of independent contractors: Two-thirds of the audited workers had no unpaid taxes; four-fifths had an average unpaid tax of only $8.32; and fourteen percent of the audited workers account for 87 percent of the unpaid tax.

The overall design of the study is highly deficient.—The sample of individuals audited is not representative of independent contractors.

The universe of independent contractors is not known, which the Treasury explicitly admits.

The sample of workers was drawn only from tax cases where employment status was under dispute.

The sample of audited workers was drawn from a larger sample which the Treasury has stated is not representative of independent contractors: Over one-third of the workers were drawn from insurance salespersons, which does not reflect the composition of the independent contractor population; and the "Direct Sales" category includes workers with occupations foreign to the industry—entertainers, drivers and a large number of unskilled laborers.

The sample was not random. Over 21 percent of the original sample could not be located and was not replaced, contributing to sample bias.

The large number of skilled and unskilled workers in the sample (almost one-half) is not consistent with the known characteristics of independent contractors.

Acceptable measures of statistical reliability have not been provided, so that the reliability of the compliance rates are not known.

For many industry and occupational groupings in the study, the number of workers audited is too small to estimate compliance with statistical reliability.

RRNA
CONSULTING ECONOMISTS

Attachment 2

AN ESTIMATE OF UNPAID TAXES OF DIRECT SALESPERSONS IN 1980*

Retail sales	$7,500 million
less: personal use	1,837 million
Salespersons' business receipts	5,663 million
less: cost of sales	3,933 million
Salespersons' gross income	1,730 million
less: business deductions	433 million
Salespersons' net income	1,297 million
Salespersons' tax liability	233 million
Unpaid tax	35 million

*This estimate is based on:

(1) Personal use of 24.5 percent of retail sales determined from industry survey.

(2) Average markup over wholesale of 44 percent determined from industry survey.

(3) Assumption of business expenses at 25 percent of gross income.

(4) Average marginal tax rate of 18 percent, determined from data in IRS, *Statistics of Income Bulletin* and based on average total household income of direct salespersons.

(5) Assumption of tax compliance rate of 85 percent based on 1979 IRS Compliance Study.

Chairman **Stark**. I think that completes the statements of this panel.

Mr. Duncan?

Mr. **Duncan**. I have no questions, Mr. Chairman.

Chairman **Stark**. Mr. Guarini?

Mr. **Guarini**. No questions.

Chairman **Stark**. Gentlemen, thank you very much.

The next panel will consist of Mr. Jerome B. Libin, counsel of National Association of Life Cos.; Mr. Gustav Lehr, president of Shelter Insurance Cos., representing National Association of Independent Insurers; Mr. Sam Brooks, president of Brooks & Co., representing Manufacturers' Agents National Association; and Mr. Thomas J. McHugh, chairman of the Taxation Committee of the National Association of Manufacturers.

STATEMENT OF JEROME B. LIBIN, COUNSEL, NATIONAL ASSOCIATION OF LIFE COS.

Mr. **Libin**. Good morning, Mr. Chairman.

Chairman **Stark**. I will call on each of you in the order you appear on the witness list.

Mr. **Libin**. I am here as counsel for the National Association of Life Cos., an association of approximately 300 life insurance companies doing business throughout the country. I am here today as Washington counsel for the association because the chairman of its executive committee, former Governor Waterfield of Kentucky, is unable to be here.

The NALC supports H.R. 6311 as an important piece of legislation that will resolve the controversy that has existed for so long in the independent contractor area. We believe it is the best piece of legislation dealing with the classification question. It has, in our view, the best chance for enactment since the Senate has already held hearings on a virtually identical bill—S. 2369.

We are anxious to see the issue resolved by the June 30 deadline. We hope there will be no need for further extensions of section 530 of the 1978 Revenue Act. We think that the safe harbor tests contained in H.R. 6311 are quite appropriate and satisfactory. They address the basic issues that have been presented and focus on the fundamental issues that separate employees from independent contractors, and they do it in a satisfactory and appropriate manner.

We, therefore, strongly urge that this subcommittee act favorably on H.R. 6311 and report it to the full committee so that the legislation can be enacted by the end of June. We realize time is running short and therefore hope that everybody will move with dispatch on the issue.

There is one peculiar aspect of H.R. 6311 that deals with life insurance agents that does require a brief comment. As you know, for social security purposes full-time life insurance agents are treated as so-called statutory employees—that is, irrespective of their independence and freedom, these agents have been designated "employees" for social security purposes. This special, statutorily mandated treatment does not, however, apply for purposes of income tax withholding.

H.R. 6311 unfortunately states that the fact that full-time life insurance agents have been designated as "statutory employees" for FICA purposes precludes these agents and their companies from relying on the safe harbor provisions of the bill for income tax withholding and other purposes.

We think that is a mistake. We don't see why the fact that a policy decision has been made for social security purposes should in any way affect the status of these individuals for withholding or other pertinent purposes. We, therefore, urge an amendment to the bill to correct this seemingly inadvertent and clearly unfair result.

We also would like to comment briefly on the compliance issue. As has been noted, the Treasury Department's 1979 compliance study has been rightfully criticized as having greatly exaggerated the level of independent contractor noncompliance. Even taking the Treasury's study at face value, however, ignoring its flaws, it provides no basis for imposing withholding on the insurance industry. Of all the industries represented in the study, the insurance industry had the highest compliance level—98.3 percent of compensation reported.

We do not, therefore, see any need whatever to impose a withholding tax burden on insurance companies. We strongly object to any legislation that would impose withholding for the purpose of collecting more taxes from insurance agents because we don't think you can do much better than 98 percent even with a perfect system.

We consequently urge enactment of H.R. 6311 with the modification I have mentioned, and we strongly hope that steps will be taken to enact the bill by the end of June. If the proposal made by a prior panelist—to allow section 530 to expire on June 30—were to occur, simply to test the waters and see what happens, without any new legislation in its place, our concern is that notwithstanding Commissioner Egger's promise to move slowly, revenue agents in the field would move quickly to reassert the common law tests, thereby resurrecting all the problems and recreating the horror stories of which the committee is well aware. We certainly don't want that situation to occur and hope you won't allow it.

Finally, we have one suggestion with respect to compliance that follows up on a statement Mr. Koplan made earlier. He expressed the view that, since independent contractors are not required to attach form 1099 to their income tax returns, compliance is low. He therefore favored withholding. We would suggest that, if compliance truly is a problem in this area, independent contractors should be required to attach form 1099 to their returns, as is now the case with form W-2 received by employees. Indeed, we frankly don't understand why they are not now required to be attached. An individual who receives a form 1099 ought to attach it to his return at the time the return is filed. That by itself would almost certainly improve compliance in this area at no cost to anyone, and should obviate any need to impose a broad scale withholding system on independent contractors.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF JEROME B. LIBIN, COUNSEL, NATIONAL ASSOCIATION OF LIFE COS.

SUMMARY OF TESTIMONY

1. The NALC urges the Subcommittee on Select Revenue Measures to act favorably on H.R. 6311. The "safe harbor" provisions of the bill will preserve the independent contractor status of commission life insurance salesmen without opening the door to wholesale abuses.

2. Although generally endorsing the compliance provisions of H.R. 6311, the NALC urges the Subcommittee to consider modifying the bill's penalty provisions to make them more easily administrable. In addition, the bill should be amended to require independent contractors to attach copies of their Forms 1099 to their income tax returns.

3. H.R. 6311's "safe harbor" tests represent a reasonable and balanced approach to the classification issue. It should be made clear, however, that a service-recipient's imposition of de minimis scheduling requirements would not cause a worker to fail H.R. 6311's "control-of-hours" test.

4. H.R. 6311's safe harbor provisions should be modified to extend, for income tax withholding purposes, to individuals who are "statutory employees" under section 3121(d) (3) of the Code. To deny safe harbor protection to otherwise qualifying workers simply because their status for FICA purposes is currently determined by statute would be not only illogical but also grossly unfair.

5. Should enactment of H.R. 6311 before June 30 prove impossible, the NALC strongly recommends that the interim relief afforded by section 530 of the Revenue Act of 1978 be continued.

STATEMENT

I appear today as counsel for the National Association of Life Companies (NALC), an association of nearly 300 life insurance companies. The NALC, whose principal office is in Atlanta, was organized in 1955. Its members are active in 40 states, Canada, and Puerto Rico, represent more than 60 million policyholders, and have more than 400,000 shareholders and 170,000 employees.

The NALC commends the Subcommittee on Select Revenue Measures for holding this hearing on legislative proposals relating to independent contractors. The independent contractor issue—the question of what standards should be used in classifying individuals as independent contractors rather than employees—is without question a vexing one. It is an issue that Congress has long wrestled with, and one the resolution of which, unfortunately, has been repeatedly deferred. That delay, it is almost universally agreed, must end. Permanent legislation should be promptly enacted to afford taxpayers the certainty and predictability they unquestionably need to plan and conduct their business affairs.

To this end, the NALC strongly urges the Subcommittee to act favorably on H.R. 6311, the independent contractor bill introduced by Congressman Gephardt and cosponsored by several members of the Committee on Ways and Means.[1] We heartily endorse the concept of an independent contractor "safe harbor" and agree that the standards set forth in H.R. 6311 represent a reasonable and balanced approach to the problem: they will preserve the traditional and historical status of certain individuals—including commission life insurance agents—as independent contractors, without opening the door to wholesale abuses.

The NALC also supports in concept the compliance provisions of H.R. 6311. We have long believed that the high level of tax compliance among insurance agents is attributable to the industry's adherence to the information reporting requirements of the Code. Accordingly, the NALC applauds the inclusion last year as part of the Economic Recovery Tax Act of 1981 of a requirement that payors provide their independent contractors with copies of Forms 1099 (something many insurance companies have long done). By enacting additional compliance provisions such as those contained in H.R. 6311, Congress will be serving notice that noncompliance among independent contractors will not be tolerated.[2]

---

[1] There are, of course, numerous other independent contractor bills before the Subcommittee. These bills are, in many respects, quite similar to H.R. 6311. Because the NALC believes H.R. 6311 (and its companion measure in the Senate, S. 2369) represents the most reasonable approach to the problem, we confine our comments to that bill. We do wish, however, to note our vigorous opposition to the withholding provisions of H.R. 5867; the proposal would burden industry with costs out of all proportion to the revenue it seeks to raise and, addition, would be completely unadministrable in its application.

The NALC suggests, moreover, that compliance could be further enhanced by requiring independent contractors to attach copies of their Forms 1099 to their income tax returns. Such a requirement (which, of course, already exists for Forms W-2) would not only make IRS "matching" easier, but it would also make it more likely that all independent contractors would in the first instance report and pay tax on the full amount of their compensation.

There is no need to belabor the past, to recount the extensive administrative and judicial precedent treating commission insurance agents as independent contractors. It is sufficient to note that, under the twenty-factor common law control test, commission insurance agents have traditionally and consistently been treated as independent contractors, and that treatment has been accepted by the IRS and sanctioned by the courts.[3]

That treatment should now be statutorily affirmed. We urge Congress to act to preserve the independent contractor status of commission insurance agents and other groups of workers who historically have been accorded that status. The safe harbor standards of H.R. 6311 will do that, and consequently, we urge prompt enactment of the bill.

H.R. 6311 represents a vast improvement over the common law control test. Two of the bill's five safe harbor tests—the "written-contract-and-notice-of-tax-responsibilities" test and the "filing-of-required-returns" test—will be comparatively easy to apply: either the tests will be satisfied or they will not. Moreover, by requiring that the individual's contract be written and that it specify his tax responsibilities as an independent contractor, those provisions by themselves should enhance compliance with the tax laws.

The bill's other three tests—the "control-of-hours," the "place-of-business," and the "investment-or-income-fluctuation" tests—focus on the essence of worker control and economic independence: whether the individual controls the time when he works, the location where he works, and how long and how hard he works. Stated differently, safe harbor protection under H.R. 6311 turns on whether the amount of money a worker earns is determined not by the mere number of hours worked, but by what is produced or how much is invested in the effort. By limiting the inquiry to five tests, the bill will enable not only taxpayers but the IRS as well to easily and fairly determine whether or not a particular individual is an independent contractor.

Given the historical treatment of commission insurance agents as independent contractors and the well-reasoned balance struck by H.R. 6311, the NALC is confident that most commission life insurance agents will easily qualify for safe harbor protection under the bill. With regard to H.R. 6311's specific tests and the Treasury Department's response to them (as reflected in Assistant Treasury Secretary Chapoton's testimony at the April 26 Senate Finance Subcommittee hearing on S. 2369), the NALC offers the following comments.

Control-of-hours test

Unlike Assistant Secretary Chapoton, who has testified that an individual's ability to control the number of hours he works and the scheduling of those hours is "seldom relevant" to a determination of his status as an independent contractor, the NALC believes inclusion of the "control-of-hours" test in H.R. 6311 is quite appropriate. Under the common law test, which focuses on the presence or absence of a "control" relationship between the service-recipient and the worker, the worker's freedom to set his own hours and scheduling can be critical in distinguishing an independent contractor from an employee. H.R. 6311 properly recognizes this fact by including a "control-of-hours" test.

---

[2] In this regard, however, the NALC shares the concern voiced at the April 26, 1982, hearing of the Senate Finance Subcommittee on Oversight of the Internal Revenue Service on S. 2369 (a bill almost identical to H.R. 6311) that the bill's penalty surcharge provisions may prove unduly complex and difficult to administer. Among the witnesses discussing this aspect of the penalty provisions were Assistant Treasury Secretary Chapoton and Mr. Daniel Stanton of the General Accounting Office.

[3] See G.C.M. 18705, 1937-2 C.B. 379; S.S.T. 249, 1938-1 C.B. 393; Rev. Rul. 54-309, 1954-2 C.B. 261; Rev. Rul. 54-312, 1954-2 C.B. 327; Rev. Rul. 59-103, 1959-1 C.B. 259; Rev. Rul. 69-287, 1969-1 C.B. 257; Rev. Rul. 69-288, 1969-1 C.B. 258; *Reserve National Insurance Co.* v. *United States*, 74-1 U.S. Tax Cas. (CCH) ¶ 9486 (W.D. Okla. 1974); *Standard Life & Accident Insurance Co.* v. *United States*, 75-1 U.S. Tax Cas. (CCH) ¶ 9352 (W.D. Okla. 1975); *Kelbern M. Simpson*, 64 T.C. 974 (1975). The independent contractor status of life insurance agents under the common law test was recently affirmed in a case involving an NALC member company. See *Investors Heritage Life Insurance Co.* v. *United States*, 79-1 U.S. Tax Cas. (CCH) ¶ 9394 (E.D. Ky. 1979), accepting and adopting magistrate's report and recommendations, 79-1 U.S. Tax Cas. (CCH) ¶ 9246 (E.D. Ky. 1979).

With respect to the application of the test to the insurance industry, the NALC urges that it be made clear that the service-recipient's requesting an agent to handle inquiries at an agency office for a few hours a week will not cause the agent to fall outside the safe harbor, for in such a situation the agent will without question continue to control the scheduling of substantially all the hours worked. In other words, the service-recipient's imposition of certain truly de minimis scheduling requirements should not cause an individual to fail the "control-of-hours" test.

Place-of-business test

Assistant Treasury Secretary Chapoton has also argued that safe harbor treatment should be predicated on the individual's maintaining a place of business separate from that of the service-recipient. It is unclear whether the Administration would require an individual who does not perform the bulk of his services at a single fixed location to have a separate place of business. Commission insurance agents, of course, fall within this category, performing their services for the most part on the road, traveling from home to home, prospective policyholder to prospective policyholder. H.R. 6311 recognizes that many independent contractors perform their services under similar conditions by providing that these individuals will be deemed not to have a principal place of business. The NALC urges the retention of this portion of H.R. 6311's "place-of-business" test.[4]

Investment-or-income-fluctuation test

Both Assistant Treasury Secretary Chapoton and Mr. Stanton of the GAO recommended to the Senate Subcommittee on Oversight that the income-fluctuation prong of this test should be modified to require that the individual bear some risk of loss. Their comments reflect a lack of appreciation about the "risks" an independent contractor takes. The risk of not earning any money at all is a very real risk: an individual who runs that risk—whose level of compensation turns exclusively on the extent of his own efforts—is economically independent, and any safe harbor bill should recognize this independence. Consequently, if an individual's remuneration is wholly sales-based, the fact that he incurs only a relatively limited amount of business expenses should not preclude his qualifying under the safe harbor provisions.[5]

Stated simply, an individual who runs the risk of earning no income at all (because he makes no sales or because the small commissions he earns are offset by his business expenses) should not be treated any different from the individual who incurs significant business expenses in his work. That the income-fluctuation test was included in H.R. 6311 as an alternative to the bill's investment test reflects a clear recognition and appreciation of this point. Any proposed modification of the alternative income-fluctuation test should be rejected.

Application of H.R. 6311 to statutory employees

As drafted, the safe harbor provisions of H.R. 6311 do not extend to individuals who are treated as employees for Social Security (FICA) purposes under section 3121(d)(3) of the Code. These individuals, including "full-time life insurance salesmen," are currently treated as independent contractors for income tax withholding purposes but as employees for FICA purposes, and they are often referred to as "statutory employees."

The NALC strongly recommends that statutory employees not be denied the opportunity to rely on H.R. 6311's safe harbor for income tax withholding purposes. Quite simply, there is no logical reason to exclude otherwise qualifying workers from the safe harbor simply because their status for FICA purposes is not determined under the common law. To afford safe harbor protection to other workers while requiring statutory employees to determine their status for income tax withholding purposes under the common law test would be not only illogical but also grossly unfair.

---

[4] Assistant Secretary Chapoton urged that workers be compelled, in effect, to satisfy the requirements of section 280A of the Code before being deemed to satisfy the "place-of-business" test. In the context of a safe harbor bill, such a requirement would be totally unadministrable. Section 280A operates to deny the taxpayer a deduction for home office expenses where that office is not exclusively used on a regular basis as a principal place of business. Absent extensive monitoring of the worker's use of his own home, it would be impossible for the service-recipient to know on a continuing basis whether a particular worker satisfied the "exclusive use" requirement of section 280A.

[5] Similarly, the service-recipient's provision of certain government-mandated materials (*e.g.*, state insurance department approved policy applications) should not, by itself, place an individual beyond the safe harbor.

The purpose of the safe harbor provisions of H.R. 6311 (and of all the other pending bills) is to provide clear standards for determining the status of individuals who in the past have been subject to the common law test. For income tax withholding purposes, "full-time life insurance salesmen" are clearly one class of such individuals, and their being subject to special rules for FICA purposes does not eliminate their need for a safe harbor for income tax withholding purposes. Consequently, we urge you to modify H.R. 6311 to allow statutory employees to qualify for safe harbor treatment. If adopted, this recommendation would not upset or in any other way affect the status of these individuals for FICA purposes. Rather, it would simply allow them, like all other individuals whose status for income tax withholding purposes is currently determined under the common law control test, to avoid the uncertainty and unpredictability of that test by satisfying the bill's safe harbor provisions.[6]

Congress should promptly enact H.R. 6311. The bill will not only protect the status of traditional independent contractors, but will provide taxpayers, as well as the IRS, with the certainty and predictability that only permanent legislation can provide.

Should enactment of such permanent legislation before June 30 prove impossible, the NALC strongly recommends that the interim relief afforded by section 530 of the Revenue Act of 1978 be continued and not be allowed to lapse.

Chairman **Stark**. Very quickly, I suspect the reason W-2's are attached is that they are needed for obtaining refunds. That is the incentive for getting the W-2. Or you need it to establish credit for withholding. There is no incentive to the taxpayer to tack the 1099 on. I agree with your idea.

Mr. **Libin**. I appreciate that, Mr. Chairman. We see no reason not to impose the requirement. If taxpayers are forced to attach their 1099's you should get much better compliance.

Chairman **Stark**. Mr. Lehr.

STATEMENT OF GUSTAV J. LEHR, PRESIDENT, SHELTER INSURANCE CO., REPRESENTING NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

Mr. **Lehr**. Thank you, Mr. Chairman. I am Gus Lehr, a member of the board of governors of the National Association of Independent Insurers, generally referred to as NAII. Today I appear on its behalf and it is the largest property and casualty trade association in the country.

First, NAII fully supports H.R. 6311. Second, I urge the members of the subcommittee to read the brief statement filed with the committee in its entirety to understand why it is absolutely essential for any independent contractor legislation to provide a safe harbor classification for independent contractors.

My story detailing the unreasonable and unfair IRS audit and litigation activities in the employment tax area is shared throughout my industry and certainly in any other industries that rely in part on independent contractors to compete in the marketplace.

The sheltered insurance companies have, since their inception, conducted business through exclusive agents whom we and they consider to be independent contractors.

Apparently the Internal Revenue Service did too, for in repeated audits over the first 26 years we were in business, the issue of whether our commission agents were employees or independent contractors was never raised; never, that is, until November of

---

[6] If this recommendation is adopted, certain conforming changes will have to be made in other provisions of H.R. 6311 (e.g., the bill's written-contract provision).

1972 when we learned the IRS was taking the formal position that our agents were employees, and assessments of allegedly unpaid taxes back through the year 1968 were made against us.

The gross assessment for the years 1968 through 1974 was $19,148,000. In addition, while never formally levied against us, we were advised that 1975 and 1976 would add an additional $8,900,000 in allegedly unpaid taxes to be assessed against us.

Needless to say, we retained counsel and resisted these assessments.

Our counsel pointed out repeatedly as they exhausted our administrative remedies that our agents were and are independent contractors, and for the Internal Revenue Service to take the position that they were employees was contrary not only to the law and regulations the IRS itself had published, but also to its stance in previous audits.

To no avail. At the time Congress granted the remedy found in section 530 of the 1978 Revenue Act, our companies were in litigation in the Court of Claims. By this time, because of abatement of some assessments through the acquisition of 466S forms, the $19 million assessment was reduced to $10 million, which sum was made up of $7 million in alleged unpaid taxes and $3 million in accumulated interest, this sum to be placed in escrow.

It should be noted we were not permitted any abatement of assessments until March of 1977. Consequently for the years 1974, 1975, and 1976, our published financial statements carried the comments that we had a contingent tax liability.

In our 1976 statements, the contingent liability amounted to $19,148,000. Our surplus for policy holder protection at that time was $57.2 million, which gave us concern and apprehension about our ability to continue as a viable organization.

This uncalled-for change of position by the IRS and its unrelenting activity under different administrations and over an extensive period of time supports without question the absolute need for legislative protection to companies such as mine and to industry.

We cannot rely on so-called good faith where none was demonstrated, and the tax collector's actions have been unbridled and unchecked.

Legislation without a safe harbor will not be acceptable to the insurance industry as I am certain to other industry groups.

We urge you to pass H.R. 6311 and end the uncertainty we face. This is not a request for legislation to enable us to create a new, different or more advantageous classification for our agents, but a request to return us to the certainty we had for 25 years before the costly, harrowing experiences which began in 1972.

H.R. 6311 is a well-balanced bill put together with the cooperation of industry groups. Every provision is interlinked. We view the bill in its entirety and support it as such and fear any substantive changes will impair that support.

In conclusion and with this understanding, Mr. Chairman, the NAII supports, without reservation, H.R. 6311.

Thank you, sir.

Chairman STARK. Thank you, Mr. Lehr.

[The prepared statement follows:]

STATEMENT OF NATIONAL ASSOCIATION OF INDEPENDENT INSURERS

SUMMARY

The National Association of Independent Insurers recommends to the Subcommittee as follows:

1. That the Subcommittee maintain the historical treatment of commission insurance agents as independent contractors.
2. That the Subcommittee be mindful of the problems created by the Internal Revenue Service's change of position and how the Congress responded.
3. That the Subcommittee accept the Gephardt and Conable proposal, H.R. 6311, as the most sensible and workable solution to the employee-independent contractor classification problem.
4. That the Subcommittee reject that portion of H.R. 6300 which would impose reporting requirements and penalties on independent contractors without clarifying their status.
5. That the Subcommittee reject H.R. 5867, which would impose unworkable withholding requirements on independent contractors.

STATEMENT

This statement is submitted by the National Association of Independent Insurers (NAII) in support of H.R. 6311, the "Independent Contractor Tax Classification and Compliance Act of 1982," a bipartisan bill introduced on May 6, 1982 by Congressmen Gephardt, Conable, Heftel and Hance. The bill clarifies the standards used for determining whether an individual worker is an independent contractor or an employee for federal employment tax purposes. It also contains measures to improve tax compliance by independent contractors.

Background concerning NAII

NAII is a voluntary, insurance company trade organization consisting of more than 500 members. Companies, both members and subscribers, now affiliated with the organization total more than 600. Members range from small companies doing business in only one state to one of the largest multi-state writers; from the highly specialized writer of farmers or other consumer groups to the so-called full multiple-line insurer; and from those merchandising their insurance products through the mails to those using various agency systems. Virtually every state is represented in the membership.

Structure of agency relationships in casualty insurance industry

A large portion of the casualty insurance issued in the United States is written by companies which utilize an exclusive agency force. Many companies of this type were organized in order to provide low cost insurance protection in rural communities, and the use of an exclusive agency force was the only effective way to compete with older insurance companies which had established ties to existing general agents. The exclusive agency insurance companies include both mutual and stock companies.

Agents representing the companies are licensed by state insurance departments and must pass a written examination prior to obtaining a license. In general, the agents in question (including both full- and part-time agents) work from their own premises (either home or office), keep their own hours, solicit insurance business in their own ways, pay their own expenses, and are compensated by commissions. The agents are widely dispersed geographically, and most operate in areas in which the companies have no office or regular employees. District or regional sales managers are available to assist the agents if the agents so request, and, except in limited circumstances, the agents do not represent competing companies. The agency representation can generally be terminated by either party upon specified notice. Most of the companies have been carrying on business in essentially the same way for more than 40 years.

Historical treatment of commission insurance agents

For purposes of the employment tax provisions of the Internal Revenue Code—the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA) and Collection of Income Tax at Source on Wages (withholding)—the standard for determining whether a worker is an independent contractor or an employee has, with certain limited statutory exceptions, been the common law test of control. As formulated in the regulations, a worker is not treated as an employee unless the person for whom he performs services has the right "to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished." [Treas. Regs. §§ 31.3121(d)-1(c)(2) (FICA); 31.3306(i)-(1)(b) (FUTA); and 31.3401(c)-1(b) (withholding)].

Application of the common-law control test to commission insurance agents, such as those engaged in selling insurance on behalf of the casualty insurance industry, has traditionally resulted in such agents being classified as independent contractors rather than employees. That the IRS concurred in this classification is demonstrated by the fact that, over a period of 30 years commencing in 1937, the IRS issued seven rulings holding that commission insurance agents are independent contractors for employment tax purposes; they are not employees. G.C.M. 18705, 1937-2 Cum. Bull. 379; S.S.T. 249, 1938-1 Cum. Bull. 393; Rev. Rul. 54-309, 1954-2 Cum. Bull. 261; Rev. Rul. 54-312, 1954-2 Cum. Bull. 327; Rev. Rul. 59-103, 1959-1 Cum. Bull. 259; Rev. Rul. 69-287, 1969-1 Cum. Bull. 257; Rev. Rul. 69-288, 1969-1 Cum. Bull. 258. The courts likewise accepted this classification. *Reserve National Insurance Co.* v. *United States,* 74-1 U.S.T.C. ¶ 9486 (W.D. Okla. 1974); *Standard Life & Accident Insurance Co.* v. *United States,* 1975-1 U.S.T.C. ¶ 9352 (W.D. Okla. 1975); and *Kelbern M. Simpson* 64 T.C. 974 (1975). There are no contrary published rulings or judicial decisions.

Hence, for many years the common-low control test afforded insurance companies, commission insurance agents and the IRS a certainty that the relationship between insurance companies and commission insurance agents was that of independent contractors and not employees. All concerned relied on the fact that, with respect to such agents, insurance companies were not required to withhold and remit income taxes and the employee share of FICA taxes, nor were they required to pay FUTA taxes and the employer share of FICA taxes. On the contrary, since commission insurance agents were universally recognized to be independent contractors, the agents were considered by all to be directly responsible for paying their own income and self-employment taxes.

IRS changes of position and congressional response

Beginning in approximately 1970, however, the IRS began to assert that commission insurance agents were employees, in disregard of the IRS's own long-established position. These assertions, which were made without the support of any published authority and without any announced change in position by the IRS, resulted in assessments being proposed or levied retroactively against insurance companies, including NAII's members, on the ground that commission insurance agents should have been treated as employees for all open years. These assessments represented, in the main, duplication of federal income and self-employment taxes already paid by agents.

Concurrent with its about-face in the treatment of commission insurance agents, the IRS also began asserting for the first time that workers performing services in many other industries were employees rather than independent contractors as they had previously been considered. For example, John M. Samuels, Deputy Tax Legislative Counsel, Department of the Treasury, expressly acknowledged that the IRS had changed its position with respect to real estate agents by issuing new revenue rulings recharacterizing the relationship between real estate firms and real estate agents. In Mr. Samuels' words: "They [the new revenue rulings] represented what could fairly be characterized as a change in position with respect to real estate salespeople." (Hearings before Subcommittee on Taxation and Debt Management Generally of the Committee on Finance, United States Senate, 95th Cong., 2d Sess. at p. 121). Similarly, in the case of *Aparacor, Inc.* v. *United States,* 556 F. 2d 1004 (1977), the United States Court of Claims stated that the Service's attempt to reclassify as employees many thousands of individuals engaged in selling products at retail on a commission basis represented "a radical departure from the traditional common law concept of an employer-employee relationship."

As a result of these IRS changes in position, confusion suddenly reigned where certainty had been the rule. Congress soon became cognizant of the problem and, during the deliberations on the Tax Reform Act of 1976, endorsed a statement in the Conference Report urging the IRS not to apply retroactively any changed position in the employment tax area pending completion of a study by the staff of the Joint Committee on Taxation. (Conf. Rep. on H.R. 10612, p. 489).

When it became clear that the IRS was not honoring the Congressional request,[1] Congress responded by enacting section 530 of the Revenue Act of 1978, which was

---

[1] The IRS' cavalier disregard of the Conference Report is illustrated by the Treasury Department's response to a request from Senator Curtis that the Subcommittee on Taxation and Debt

Continued

designed to provide interim relief for taxpayers while Congress develops a comprehensive, permanent solution to these controversies. In general, section 530 terminates pre-1979 employment tax liabilities of taxpayers who had a reasonable basis for treating workers other than as employees. Several "safe havens" were established which, if satisfied, entitle taxpayers to relief. In addition, section 530 allows such taxpayers to continue to treat workers as other than employees through 1979.

While the relief provided by section 530 did much to assuage the concerns resulting from the uncertainty caused by the IRS changes in position, the solution provided by that section is, by design, only an interim one; the relief extends only through June 30, 1982. Therefore, immediate action must be taken by Congress. As Congressman Gephardt has aptly stated: "The need for certainty in this area is obvious. Where the worker is an "employee," the "employer" is required to serve as a collecting agent for the Government, withholding and remitting income and social security taxes from the remuneration paid to the worker. Consequently, it is essential that companies be given clearer indications, before the fact, of their obligations in this regard. This was highlighted by the recent decision of the Supreme Court of the United States in a case involving the issue of whether lunch expenses constituted wages subject to withholding." There, the Court stated:

"Because the employer is in a secondary position as to liability for any tax of the employee, it is a matter of obvious concern that, absent further specific congressional action, the employer's obligation to withhold be precise and not speculative. *Central Illinois Public Service Co.* v. *United States*, 435 U.S. 21, 31 (1978)."

If action is not taken promptly to provide a permanent solution, the uncertainty and chaos which existed in the years prior to the enactment of section 530 will likely return.

Reasons for NAII members' concerns—problems created by change of agents' employment tax status

Commission insurance agents, insurance companies and individuals and companies in other affected industries will face enormous problems as a result of uncertainties as to employment tax status. These problems include the following:

1. *Social and economic impact.*—Commission insurance agents have traditionally and historically viewed themselves, and have been viewed by others, as independent businessmen whose success is attributable to their individual initiative and independent operations. As such, they rightfully take pride in their status as independent entrepreneurs. If Congressional action is not taken to reaffirm that these individuals are indeed independent contractors, long-established social and economic relationships will be threatened, with reverberations reaching far beyond the employment tax area.

2. *HR-10 Plans.*—A large number of commission insurance agents have adopted self-employed persons' pension or profit-sharing plans (HR-10 plans), many of which have been approved by the IRS. If the IRS should again be free to assert that these agents are employees rather than independent contractors, the status of these numerous plans would be placed in doubt. The specter would exist of having these plans retroactively disqualified, since the individuals who adopted them might be deemed to be employees and therefore not entitled to maintain HR-10 plans. The result could well be a review of numerous income tax returns of commission insurance agents. If the agents had previously received determinations from the IRS that they are independent contractors and are then reclassified as employees, the plans would be frozen and any future contributions would not be exempt from tax. If the agents had not proviously received such determinations, the plans would be disqualified, and all amounts in the plans (previous contributions plus income) would

---

Management Generally be provided with "all directions, bulletins, letters, communications, regulations, and so on" that were sent out to all IRS offices and employees instructing them to follow the language of the Conference Report. The Treasury Department indicated that the Congressional request was essentially meaningless and that, accordingly, no such communications had been sent out: "The conferees on the Tax Reform Act of 1976 urged the Internal Revenue Service not to apply to past tax years any changed position or any newly stated position which is inconsistent with a prior general audit position in this area. The term "general audit position" has little or no meaning. Determinations as to whether workers are employees or independent contractors are made by applying the longstanding common law rules on a case-by-case basis, in accordance with the regulations and revenue rulings which were in effect before the Conference Report was issued. However, to the extent that it is possible to identify a "general audit position"—and hence to depart from such a position—such departures are initiated only by the National Office of the Internal Revenue Service. Therefore, it was not necessary for the National Office to instruct field offices not to make such departures." (Hearings before Subcommittee on Taxation and Debt Management Generally of the Committee on Finance, United States Senate, 95th Cong., 2d Sess. at p. 220).

be taxable. The potential adverse consequences of such a disqualification would be substantially increased for any commission insurance agent who might choose to take advantage of the increased contribution levels approved last year as part of the Economic Recovery Act of 1981.

3. Effect on State income tax liability.—The Federal employment tax classification of workers as employees or independent contractors is paralleled by many state income tax statutes. The rules for withholding of state income taxes generally coincide with federal withholding rules. Moreover, like federal exclusions and deductions, the applicability of certain exclusions and deductions under state law may depend on whether a worker is an employee or an independent contractor. For example, in order to claim business expenses as "above the line" deductions from gross income in determining federal income tax liability, a worker must usually be self-employed. Obviously, if the employment tax status of insurance agents and other workers is not clarified by Congress and is subsequently challenged by the IRS, these workers could face substantial state tax deficiencies.

4. Status of employees of agents.—Many commission insurance agents have their own employees. Absent Congressional clarification of the standards for differentiating between employees and independent contractors, serious questions will exist as to the status of employees of such agents. The insurance companies have no control over the hiring, firing, compensation, or supervision of agents' employees, who may suddenly be treated as employees of the companies.

5. Company pension and profit-sharing plans.—Qualified pension and profit-sharing plans maintained by insurance companies have not provided for the coverage of agents—in accordance with published pension trust section rulings which flatly state that commission insurance salesmen cannot be covered under a qualified plan. If the employment tax status of commission insurance agents should again be subjected to challenge, these qualified plans may be disqualified for failure to cover the agents in question. This could result in the disallowance of contributions, a tax on the income of the plans, and direct injury to thousands of employees who are beneficiaries of the plans. A report issued by the General Accounting Office documented that such an outcome is not purely theoretical. The report disclosed that in one instance a company had established a generous retirement plan for its office employees. After the IRS determined that the company's independent contractors should have been classified as employees, the company was forced to terminate the office employees' pension plan because it could not afford to extend the plan to the individuals who had been reclassified as employees. The result was that the reclassified individuals lost their eligibility to establish HR-10 plans and the office employees lost their retirement benefits. ["Report to the Joint Committee on Taxation, Congress of the United States, by the Comptroller General of the United States—Tax Treatment of employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions," pp. 15-16 (November 21, 1977) (hereinafter referred to as the "1977 GAO Report")].

6. Penalizing effect of changes in status.—Should the IRS again be free to throw down the gauntlet on this issue, insurance companies would be faced with substantial burdens in the operations of their businesses even if they should ultimately prevail in establishing that their commission agents are independent contractors. Challenges by the IRS would give rise to contingent liabilities which ordinarily must be noted for financial statement purposes. As a result, the ability of insurance companies to raise capital, borrow money, take advantage of business opportunities, and even to sell insurance might be impaired. Additionally, the companies might be subjected to tax liens for the unpaid, disputed tax liabilities, or to the substantial costs of posting bonds or collateral.

7. Impracticability of withholding.—If the IRS is permitted to resume its attempts to change the classification of commission insurance agents from independent contractors to employees, significant problems concerning withholding of income taxes and the "employee's" share of FICA taxes, as well as the company's liability for the "employee's" share of FICA taxes, as well as the company's liability of the "employer's" share of FICA taxes, would result. Identical problems would arise under the withholding requirements of H.R. 5867, introduced March 17, 1982. These problems are discussed in detail below.

8. Effects of competitive relationships.—Absent Congressional clarification of the standards for determining the employment tax status of workers, companies subjected to IRS challenge as to the employment tax status of their commission insurance agents may be placed at a competitive disadvantage with respect to other insurance companies. The example posited by the Staff of the Joint Committee on Taxation is illustrative: "[A]ssume that the A company and the B company are substantially similar enterprises, and that A's workers are treated as independent contractors, while B's workers (who perform functions identical to those of A's workers) are treated as employees. (This difference in treatment could be explained either in terms of each business' interpretation of the common law test, or by virtue of a reclassification of workers by the Service pursuant to an audit.) In such an instance, the B company must withhold income taxes from its worker's compensation, and pay an employee's share of employment taxes. Moreover, B must comply with the various obligations pertaining to recording and depositing such funds, in addition to furnishing each employee with an annual statement as to that employee's taxes. On the other hand, the A company simply must record the amounts paid to its workers in such a manner that A can substantiate the payments for tax purposes generally, and determine whether the aggregate annual payments to any worker necessitates the filing of information returns. While A's failure to satisfy the latter obligation could result in a $1 penalty per covered payment, B's failure to comply with its obligations could result in substantial penalties. Thus, because of the significantly different obligations of each company, A might have a competitive advantage over B." ["Issues in the Classification of Individuals as Employees or Independent Contracts: A Report Prepared by the Staff of the Joint Committee on Taxation," p. 21 (February 28, 1979)].

Notably, even if a withholding proposal were enacted into law, it would not resolve the employment tax status of workers. Accordingly, the risks of companies being subjected to competitive disadvantages as a result of IRS challenges to the status of commission agents would remain.

H.R. 6311 provides a sensible, workable solution

If problems such as these are to be avoided, Congress must take immediate action to provide definitive standards for determining the employment status of workers in industries, such as the insurance industry, where the IRS created havoc by reclassifying workers as employees. We believe that H.R. 6311 will accomplish this end by providing standards which will preserve the status of workers who have historically been recognized by all to be independent contractors. These standards are comparable to the safe harbor provisions of S. 2369 (introduced by Senators Dole, Grassley, Chafee, Domenici, Danforth and Stafford), which were endorsed by the Section of Taxation of the American Bar Association on May 16, 1982.

The safe-harbor approach of H.R. 6311 recognizes, as did the 1977 GAO Report, that it is not feasible to impose a rule that will clearly establish the status of all workers. Any bill attempting to do that would likely produce arbitrary results which would impose unnecessary hardships on both workers and those for whom services are performed. The harm caused by such an approach could be as bad as that caused by the Service's past changes in position. No such broad-brush approach is necessary.

What is necessary is to restore to workers and companies in the industries affected by the IRS reclassification program the certainty as to employment status which has long existed and upon which those individuals and companies have relied in establishing their relationships and planning their affairs.

H.R. 6311 will accomplish this result. The five-factor test which it adopts as a precondition to coming within the "safe harbor" will restore to this confused area of the tax law the certainty which is so vital. It will permit both individual workers and companies in the affected industries to know with a high degree of assurance both the nature of their relationships and their respective employment tax responsibilities. At the same time, the Government will be provided the information necessary to insure compliance with the tax law.

Thus, for example, H.R. 6311 will restore to commission insurance agents and the companies for which they sell insurance the certainty that theirs is an independent contractor relationship. They will be able to meet the tests of H.R. 6311 which go to the substance of the relationship without making changes in the way they have traditionally structured their relationships and conducted their businesses.

Control of hours.—Commission insurance agents have historically controlled both the number of hours they spend selling insurance and the scheduling of those hours.

Place of business.—The majority of commission insurance agents operate out of their own homes or offices. They do not conduct their business in offices provided by insurance companies.

Income fluctuation or investment.—By the very nature of being remunerated on a commission basis, commission insurance agents have no assurance that their income will bear any relation to the amount of time devoted to selling insurance. Rather, commission insurance agents assume the risk of fluctuations in income based on their own degrees of success in selling insurance. Moreover, insurance agents who receive override commissions based on the sales of others with whom they work jointly or whose activities they oversee likewise have no assurance that their income will bear any relation to the amount of time they spend in their endeavors; they bear the risk of significant income fluctuation.

Since many commission insurance agents maintain offices, they would also meet the alternative test of the bill—substantial investment in assets.

These tests would take effect on June 30, 1982 or on the date H.R. 6311 is enacted, whichever is earlier. By virtue of complying with these tests, which go to the substance of the relationship, commission insurance agents and insurance companies will again be able to operate with the assurance that their relationship is, as it has always been, not one of employment, but of independent contractors. In short, H.R. 6311 will codify what has always been understood. At the same time, the tests set forth in H.R. 6311 should not allow parties artificially to assume the posture of independent contractors, since each of the tests is by its very nature inconsistent with an employer-employee relationship. One who sets his own hours of work, maintains his own place of business, and whose income is not directly tied to the amount of time spent working or who has a substantial investment in the assets of the business is not an employee. And one who is an employee will not be able to meet these tests. Accordingly, H.R. 6311 will not allow individuals and companies which have traditionally operated in an employment relationship to escape their employment tax responsibilities.

In addition, beginning in 1983, H.R. 6311 requires that the worker must perform services pursuant to a written contract which provides that the worker will not be treated as an employee. The worker must also be informed either in the contract or at the time it is executed of the tax obligations imposed on him as an independent contractor. H.R. 6311 thereby ensures that those who seek to come within its safe habors will know what their status is and what their resulting tax responsibilities are.

Penalties and reporting requirements.—H.R. 6311 provides a new system of penalties designed to put teeth in the information reporting requirements. With respect to payment for services over $600 after 1982, the bill requires that the person for whom services are performed must file information returns with the Government. In addition, independent contractors must be given a statement similar to Form 1099. For each failure to file such returns or provide such statements, H.R. 6311 imposes a penalty equal to 1 percent per month of the payments not reported, up to a maximum of 5 percent. The penalty is doubled and tripled for numerous failures. The minimum penalty is $50 for each failure to file an information return or to provide a statement to independent contractors.

Significantly, H.R. 6311 provides that no penalties are imposed if the failure to file a return or provide a statement is due to reasonable cause and not willful neglect. This provision is particularly important since the penalties in H.R 6311 are not limited to situations in which the parties are relying on the safe-harbor provisions to establish the existence of an independent contractor relationship. The reporting requirements are sometimes unclear with respect to people who render services and who might be considered independent contractors under the common law. Thus, without a reasonable cause provision, insurance companies could be assessed a penalty for failing to furnish statements in situations where they reasonably believed no statements were required. For example, in Rev. Rul. 81-232, I.R.B. 1981-40, 10, the Internal Revenue Service ruled that an insurance company which paid an unincorporated shop to repair an insured automobile was required to include in the Form 1099 not only the amounts paid for labor and services, but also the amounts paid for parts. The IRS reasoned that the obligation to furnish parts was incidental to the obligation to repair the car. Prior to this ruling, the reporting obligation of insurance companies in this situation had been unclear. The provision in H.R. 6311 that penalties will not be applied where the failure to file or furnish statements is due to reasonable cause and not willful neglect should protect taxpayers who find themselves in situations where it is unclear whether an obligation to file a report exists.

H.R. 6311 also provides that an independent contractor must furnish his correct Social Security or identification number to the person for whom he performs services. This provison will allow the Government to detect unreported payments by matching information returns against the income tax returns filed by the independent contractors. H.R. 6311 requires the person for whom services are performed to withhold taxes at 15 percent if the independent contractor fails to furnish his identification number or furnishes an incorrect number. The bill imposes similar reporting requirements and penalties for direct sales of certain consumer goods in the home after December 31, 1983.

H.R. 6311 creates a workable and equitable reporting system under which each taxpayer will bear his fair share of the tax burden. Accordingly, the bill completely answers the concerns expressed by the Department of the Treasury and the Internal Revenue Service in a joint letter appended to the 1977 GAO Report. Those concerns were that a change in the law might increase the number of self-employed persons, that self-employed individuals allegedly have a low compliance rate in reporting income earned, and that consequently such a change might result in lost tax revenue. NAII seriously doubts the validity of these concerns, at least with respect to the casualty insurance industry, since studies have shown an extremely high level of compliance by insurance agents associated with member companies of NAII. Indeed, even a limited compliance study conducted by the Internal Revenue Service shows that 98.3 percent of compensation received by casualty insurance agents is reported. (See Statement of Donald C. Lubick, Assistant Secretary of the Treasury (Tax Policy) before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, Table 9, June 20, 1979). It is readily apparent that the matters over which Treasury and the Internal Revenue Service have expressed concern will not come about under H.R. 6311 since the tests which have been incorporated into the bill cannot be met by an individual who is properly classified as an employee, and since the penalties and reporting requirements in the bill will enable the Internal Revenue Service to enforce compliance with the tax laws.

H.R. 6300 is not an adequate solution because it provides no standards for classifying employees and independent contractors

H.R. 6300, introduced by Chairman Rostenkowski on May 6, 1982, is an unacceptable alternative to H.R. 6311. H.R. 6300 requires persons who receive services over $600 from independent contractors to file information returns with the Government and to supply the independent contractors with a statement similar to Form 1099. H.R. 6300 imposes a penalty of $50 for each failure to file a return, up to a maximum of $50,000. The penalty is increased for intentional failures to file. No penalties are imposed if the failure is due to reasonable cause and not willful failure. Similar provisions apply to certain direct sales by independent contractors.

NAII has no objection to the reporting requirements and penalties of H.R. 6300 in themselves. However, NAII strenuously opposes H.R. 6300 because it would impose such requirements and penalties on independent contractors without first defining who they are. Thus, it would leave totally unanswered the basic issue which has given rise to the entire problem—finding workable standards for determining whether, for Federal employment tax purposes, an individual worker is an independent contractor or an employee.

Under H.R. 6300, payors and individual workers would remain in the quagmire which existed in the common law prior to the enactment of section 530 of the Revenue Act of 1978. In view of the IRS' recognized history of "radical departure[s] from the traditional common law concept of an employer-employee relationship," how would payors know with certainty whether they had a liability for FUTA tax with respect to individual workers? How would payors determine with certainty whether they had a liability for the employer's shares of FICA taxes? Individual workers would be left in the same quandary. They would have no sound basis for determining whether their remuneration is subject to withholding or to self-employment taxes. Similarly, their HH-10 plans, and the pension and profit-sharing plans set up by companies for which they perform services, would remain subject to disqualification should the IRS determine that they are employees and not independent contractors under the IRS' distorted reading of the common-law control test.

To impose reporting requirements and penalties on independent contractors without defining who is an independent contractor would be unfair and counterproductive. Independent contractors are eager to comply with the tax laws in good faith; they deserve clear standards to guide them. The Supreme Court has expressly recognized this fact. It held that the "obligation to withhold [must] be precise and not speculative," especially in this area of the tax law, where employers are required to act as collection agents for the Government. *Central Illinois Public Service Co.* v. *United States,* 435 U.S. 21, 31 (1978). H.R. 6300 falls far short of this admonition since it leaves the classification of employees and independent contractors uncertain.

NAII believes that H.R. 6300 is not the proper forum in which to address the many complex issues involved in the taxation of independent contractors. H.R. 6300 deals with a wide array of problems that are completely unrelated to the issues concerning independent contractors. For example, H.R. 6300 contains provisions involving abusive tax shelters, illegal income from criminal activities, interest and dividend payments, foreign tax activities, pensions and annuities, and IRS examinations of partnerships and subchapter S corporations. H.R. 6300 cannot resolve the problem now confronting independent contractors by attempting to deal only with the compliance aspect of the problem. Instead, a comprehensive solution of the classification, as well as the compliance, issues involved in this area of the tax law is needed. H.R. 6311 is such a solution. Thus, NAII respectfully urges that the independent contractor compliance provisions be deleted from H.R. 6300 and that the Subcommittee recommend the enactment of H.R. 6311.

H.R. 5867 is not a solution because its withholding requirements are unworkable

Although H.R. 5867, introduced by Congressman Guarini on March 17, 1982, attempts to provide a comprehensive tax treatment of independent contractors, it is not a solution because its withholding requirements are unworkable. It is difficult, if not impossible, for insurance companies to withhold taxes on the commissions paid to insurance agents because these commissions constitute gross income. From these the agents must deduct business expenses, which could include such things as wages of the commission agent's employees, office expenses, and automobile expenses. The insurance company has no way of determining the amount of these expenses. Obviously, such gross commissions cannot be equated with "wages" in any fair interpretation of the term.

Withholding on gross compensation, whether in the form of commissions to insurance agents or in some other form, can also have a significant adverse impact on the individual workers, since they could well face problems of overwithholding of income tax. Even if such individuals were extended the right to claim additional personal exemptions on their employee withholding statements to reduce the amount withheld from their gross income, it might be difficult, if not impossible, to estimate the amount of future commissions and expenses, and thus the number of exemptions to claim

To avoid withholding under H.R. 5867, an insurance agent would be required to certify that the aggregate amount withheld could reasonably be expected to exceed the amount of his income tax liability less allowable credits. This provision puts an unreasonable burden on insurance agents to estimate the amount of their future commissions and expenses and to calculate their income tax liability long before the end of the taxable year.

The withholding provisions of H.R. 5867 are not only unworkable and unfair, but also unnecessary. As noted above, even IRS studies have shown that commission insurance agents, like those associated with member companies of NAII, have a high level of compliance. Moreover, the information reporting requirements of H.R. 6311 would increase compliance considerably. (See Statement of Roscoe L. Egger, Jr., Commissioner of Internal Revenue, before the House Ways and Means Committee, p. 7, May 18, 1982.) Thus, the withholding provisions of H.R. 5867 would impose unreasonable burdens on insurance agents and insurance companies, but would not create significantly greater benefits to the Government than H.R. 6311. NAII therefore respectfully urges the Subcommittee to reject H.R. 5867 and to recommend the enactment of H.R. 6311.

Conclusion

NAII believes that H.R. 6311 will protect the interests of all concerned. Those whose longstanding status as independent contractors has recently been challenged by the Service's reclassifications program will receive the necessary reaffirmation that their independent contractor relationships will not be changed. Those who are not entitled to independent contractor status will not be able to utilize the provisions of H.R. 6311 to assume that status. And the Government has been given the tools and information necessary to ensure that those who seek the safe harbors of the bill are complying with their obligations under pertinent provisions of the tax laws.

NAII believes H.R. 6311 provides the comprehensive solution which the Congress indicated it was seeking when it enacted the interim relief provision in the Revenue Act of 1978. H.R. 6300 is not an acceptable solution because it provides no standards for classifying employees and independent contractors. Nor is H.R. 5867 an acceptable solution since its withholding requirements are impracticable and unnecessary. Thus, we urge the Subcommittee to recommend the enactment of H.R. 6311.

NAII is aware that sufficient time may not remain to permit the Congress to enact such a bill which will once and for all resolve the problems in this area prior to June 30 of this year. Therefore, if the Congress should again conclude that a prospective solution to this most difficult problem cannot be timely enacted, NAII urges that the relief provisions of section 530 of the Revenue Act of 1978 be extended until a definitive solution is forthcoming.

Chairman STARK. It gives me a great pleasure to introduce the next witness, Sam Brooks, from my hometown of Alameda, Calif. He is here representing the Manufacturers' Agents National Association.

Sam, it is a privilege to have you appear before the committee this morning. Proceed to summarize your testimony in any manner you see fit.

STATEMENT OF SAM F. BROOKS, PRESIDENT, BROOKS & CO., ACCOMPANIED BY A. STEVEN YOUNG, LEGISLATIVE REPRESENTATIVE, REPRESENTING MANUFACTURERS' AGENTS NATIONAL ASSOCIATION

Mr. BROOKS. Thank you, Mr. Chairman and members of the subcommittee. You have my written statement, but I am going to condense it in the interest of saving some time.

My name is Sam F. Brooks, and I am president of Brooks & Co., an Alameda, Calif., based manufacturers' agency specializing in the sale and marketing of aluminum extrusions, die castings, plastics, and stampings to the northern California and Nevada original equipment markets.

I am appearing here today on behalf of Manufacturers' Agents National Association, the national professional association of manufacturers' agents and their principals.

Accompanying me today is Mr. Steven Young, the association's legislative counsel.

Founded in 1947 and now representing nearly 7,000 manufacturers' agencies nationwide, MANA is the longest established and most broadly based manufacturers' representatives organization in the country.

All of MANA's regular members, including my firms, Brooks & Co., operate as independent contractors. Independent manufacturers' agencies contract with manufacturers on an individual basis to offer a sales and marketing service in a predetermined, exclusive territory.

Our compensation consists solely of commissions received on goods sold and shipped into our marketing areas; we do not take title to—that is, buy and resell—the products of the companies we represent.

We are paid by commission, and out of that gross amount comes all business operating expenses, including travel, rents, capital expenditures, staff salaries and payroll, and income taxes.

We are under written contract with each of the firms we represent, stating terms such as territory, commissions and most significantly, the relationship created—that of independent contractor and principal.

Under this agreement, it is the sole responsibility of Brooks & Co. to file quarterly tax payments, FICA, FUTA, and Federal withholding—while my principals, in turn, file annually the form 1099.

Manufacturers' Agents National Association continues to support legislation that will clarify the status of independent contractors for employment tax purposes, and to oppose proposals calling for automatic withholding from payments made to them.

Independent manufacturers' representatives and the manufacturers they serve must be able to operate with a degree of certainty that their independent contractor/principal relationship will not come under repeated scrutiny by the Internal Revenue Service.

At hearings before this subcommittee in July 1979, MANA testified that independent contractors need a workable and definitive set of standards to define their status, and that continued uncertainty in this area would have a negative impact on those industries utilizing the services of independents.

In one case, the Internal Revenue Service held that certain manufacturers of electronic components were liable for a manufacturers' agency's FICA, FUTA, and Federal withholding for the 1980 tax year simply because that agent submitted marketing forecasts on forms provided for that purpose by his principals.

Operating under ambiguous employment classification standards, IRS interpreters considered sales forecast forms to be a measure of direct control, sufficient reason, in their view, to make an independent manufacturer's agency an employee of the manufacturers he served.

This is the kind of problem which in our view the safe harbor approach introduced in the 96th Congress will solve directly.

Under this test, an independent contractor: One, controls the number of hours worked; two, is not provided with a place of business by the service recipient; three, has a substantial investment in capital assets and risks income fluctuation based on sales or other output; four, performs the service under the terms of a written agreement outlining a specific independent contractor/payor relationship, and five performs services for a recipient who files all reporting forms as required by section 1041 A of the Tax Code.

Two bills now pending before this subcommittee provide for enactment of what we consider to be an acceptable safe harbor test: H.R. 6311 by Congressmen Conable and Gephardt and H.R. 4971 by Congressman Philip Crane.

Both bills address the central concerns of independent contractors, that their independent status be statutorily defined and not subject to varying interpretation by the IRS, and also the concerns of those in Congress and the administration with reported taxpayer noncompliance in the independent contractor sector.

Measures proposed by H.R. 6311 will mandate stricter penalties for those who fail to comply with information reporting requirements under section 6041 A of the Tax Code.

This we support. It is our view that existing reporting and compliance measures, specifically the 1099 system, must be capable of providing the IRS with the necessary information it needs to monitor tax compliance.

H.R. 6311 does not place any additional burden on those who comply; it merely increases the price of noncompliance.

Manufacturers' agencies and their principals, by the very nature of their relationship, have and will continue to meet the requirements of the Tax Code in the area of payroll taxes and payment reporting.

H.R. 6311, by enacting an equitable safe harbor and insuring proper compliance will, we think, solve the controversy surrounding this issue.

Congressman Crane's bill, H.R. 4971, also provides for safe harbor test, a test which MANA can support. But it also requires the Secretary of the Treasury to conduct a comprehensive study of the 1099 system's effectiveness in insuring taxpayer compliance. We support this initiative as well.

The 1099 system was established to provide the IRS with the information it needs to monitor tax payments. If it is found that this system is somehow deficient, then Congress should consider remedies to correct it.

While MANA has consistently supported safe harbor legislation, we have vociferously opposed efforts to impose an automatic 10 percent withholding from all payments made to independent contractors, including manufacturers' agencies.

In hearings before this subcommittee in July 1979, MANA voiced its vehement opposition to the Carter administration's plans to withhold 10 percent from an independent contractor's payments, and it was on this premise that the association opposed H.R. 5460 of the last Congress.

H.R. 5460, and its 97th Congress counterpart, H.R. 5867, sponsored by Congressman Guarini, have taken the widely supported 5 point safe harbor test, resurrected the Carter administration's controversial 10 percent withholding provisions, and combined them into one measure.

For manufacturers' agents—and the manufacturers they represent—it is an unacceptable proposal.

Manufacturers' agents and their principals are in full compliance with payroll tax requirements through the provisions of the existing 1099 system, and to subject an agency's commissions to a 10-percent withholding would not only jeopardize an agent's business operations, but would also be burdensome to those manufacturers using his services.

For agents, that 10 percent of gross commission receipts often represents his only discretionary income, his company's net profit.

For manufacturers, the additional recordkeeping requirements imposed would have the effect of placing manufacturing firms in the position of monitoring and collecting taxes for the Internal Revenue Service.

One manufacturer recently reported that if such a system were to be implemented, he would be better served by replacing his manfacturers' representatives with a direct-mail marketing system. The administrative costs, he said, would be much lower than withholding from his agents' commissions.

MANA remains unalterably opposed to mandatory withholding provisions like those contained in H.R. 5867. We are happy to note that H.R. 6311, except in those cases where an independent contractor refuses to voluntarily supply information to the service recipient, abandons this coercive approach to payroll tax compliance.

MANA reiterates its continuing support for passage of a statutory definition of independent contractors, and our strong support for efforts to insure compliance through use of the reporting mechanisms now in place.

Congress must first insure that the reporting systems currently in place are reliable before seeking to impose additional taxes on those who are already in compliance with the law.

We support H.R. 6311 and the safe harbor test which it provides, and we urge the subcommittee to adopt this approach and end the uncertainty over this issue which has lingered since 1978.

This past week, Mr. Chairman, I asked one of my manufacturers how he felt about this proposed legislation and was told that if the legislation went through where he would have to file withholding tax on my commissions, that he thought he would probably do away with his entire sales force and go to a direct selling program by mail.

These are the things I am concerned about. I represent seven people in California, seven manufacturers. If all seven would go along with this one's idea, I might be coming to see you for a job.

Chairman **Stark**. You would be replaced by the postman.

Mr. **Brooks**. Thank you.

That concludes my statement.

Chairman **Stark**. Sam, thank you very much.

STATEMENT OF THOMAS J. McHUGH, CHAIRMAN, TAXATION COMMITTEE, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. **McHugh**. Thank you, Mr. Chairman.

My name is Thomas J. McHugh. I am vice president of Taxes of Dart & Kraft, Inc., testifying today on behalf of the National Association of Manufacturers.

Accompanying me is Mr. David Miller, director of taxes for the association.

NAM represents nearly 12,000 member firms who account for nearly 80 percent of the Nation's industrial output and 85 percent of the Nation's industrial work force.

As chairman of the NAM taxation committee, I am pleased to offer the association's views on the classification of persons as employees or independent contractors.

As you might imagine, NAM's contract with very large numbers of self-employed persons, providing the entire range of goods and services from raw materials to final sales. Consequently the NAM is acutely interested in issues presented by the classification of workers as employees or independent contractors.

The ultimate object of these hearings is legislation providing taxpayers and the Treasury with much-needed guidance on the classification of persons as either independent contractors or employees.

It should be noted that this meets with needs of income withholding and payroll tax purposes only, and we think any legislative resolution should be expressly restricted to these areas.

The controversy in this area has in large part resulted from increased activity by the Internal Revenue Service's employment tax compliance program.

Since the late sixties, the Service has been increasingly aggressive in its attempts to reclassify workers as employees. These reclassifications have an essentially retroactive effect and have presented many businesses with huge unforeseen back liabilities. These reclassifications have also threatened the qualification of certain retirement plans.

For example, the previously qualified retirement plan could fail to meet maximum coverage requirements if certain workers were reclassified as employees, and persons who set up several employed H.R. 10 plans could find those plans disqualified.

This increased activity by the IRS has been the prime reason for a series of interim relief provisions beginning in 1978 under which the Treasury has been prohibited from issuing new regulations or rulings in this area.

The most recent such moratorium expires June 30, 1982. The purpose of this interim relief was to allow the Congress sufficient time to consider a resolution of the independent contractor status controversy.

It is important for this committee to segregate the immediate and long-term problems in the independent contractor area.

The single most pressing need is for legislative clarification on the proper classification of workers as either employees or independent contractors.

The NAM is concerned that attempts to address important but less critical matters may lessen the chances for passage of the essential guidance on classification.

For example, questions of social security funding, SECA tax rates, and withholding proposals should take a subordinate priority to legislation which will assure payors of some certainty in the employment tax area.

In the absence of legislation providing some measure of employment tax certainty, no company can budget, predict, or price its product with reasonable expectations of what its ultimate tax liability will be.

These concerns are even more acute for smaller businesses which do not have the cash reserves or the access to credit of larger firms.

Consequently, the NAM supports the safe harbor provisions of H.R. 6311 introduced by Congressman Gephardt and Congressman Conable.

The safe harbor approach of the bill will allow most companies to predict, with a fair degree of certainty, the extent of their employment tax liabilities.

The classification of the independent contractor relationship in the manufacturing community is that of the manufacturer's representative.

Representatives will usually provide services for several manufacturers, but they will typically stay within related industrial groups.

Nearly without exception the representative will control the hours worked and will not have a principal place of business provided to him by the service recipient.

As a result, representatives satisfy the first two of H.R. 6311's five requirements.

While a representative's investment in assets used in connection with the performance of services may in certain instances be less than the substantial amount required, the bill's alternative test of income fluctuation would clearly be satisfied by the standard commission relationship between the manufacturer and his representative.

The existing manufacturer-representative relationship will not be disturbed by H.R. 6311, provided that the parties comply with the fourth requirement of a written contract and notice of tax responsibility.

While this new requirement would be something of an administrative burden, it is an acceptable one in order to achieve the certainty and predictability needed in the withholding and payroll tax areas. NAM sees no problem with the fifth requirement of filing of information returns.

The five part safe harbor test will not identify all independent contractors. Those independent contractors that are not able to achieve that status through the safe harbor approach will still be able to qualify as independent contractors under common law principles. NAM believes that the alternative of classification under common law is an integral part of any solution and should be retained as part of any final legislation.

Mr. Chairman, our complete statement includes comments on compliance and some procedural matters as well.

Thank you.

Chairman STARK. Without objection, Mr. McHugh, your entire statement will appear in the record.

[The prepared statement follows:]

STATEMENT OF THOMAS J. MCHUGH ON BEHALF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS

My name is Thomas J. McHugh. I am Vice President, Taxes of Dart & Kraft, Inc. and am testifying today on behalf of the National Association of Manufacturers. NAM represents nearly 12,000 member firms who account for nearly 80 percent of the nation's industrial output and 85 percent of the nation's industrial workforce. As Chairman of the NAM's Taxation Committee, I am pleased to offer the Association's views on the classification of persons as employees or independent contractors.

INTRODUCTION

As you might imagine, NAM's members contract with very large numbers of self-employed persons providing the entire range of goods and services from raw materials to final sales. Consequently, the NAM is acutely interested in issues presented by the classification of workers as employees or independent contractors.

The ultimate object of these hearings is legislation providing taxpayers and the Treasury with much needed guidance on the classification of persons as either independent contractors or employees. It should be noted at the outset that this need relates to income withholding and payroll tax purposes only, and we think any legislative resolution should be expressly restricted to these areas.

The three taxes at issue are: (1) Social Security taxes under either the Federal Insurance Contribution Act (FICA) for employees or the Self-Employment Contribution Act (SECA) for independent contractors; (2) Unemployment taxes under the Federal Unemployment Tax Act (FUTA); and (3) Withholding under the general income tax.

EFFECTS OF CLASSIFICATION

If a person is classified as an employee, the employer is liable for the employer's share of the FICA tax, presently 6.7 percent of the first $32,400 in wages. The employer must also withhold from the employee an equal amount as the employee's share. Also a FUTA tax is imposed on the employer at the rate of 3.4 percent on the first $6,000 of wages (minus a state tax offset). Finally, employers are required to withhold a portion of wages to satisfy an employee's income tax liability.

If a person is classified as an independent contractor, such person must pay a SECA tax of 9.35 percent on the first $32,400 of net earnings (as opposed to gross wages). Neither the contractor nor his payor have any FUTA or income tax withholding obligations. However, for income tax purposes the contractor will likely be required to file a declaration of estimated tax and periodic tax payments. Payors engaged in a trade or business generally must file information returns with respect to payments of $600 or more in a year. These returns are filed on an annual basis and payors must account for cumulative amounts during the year.

The Administration and others have contended that there are strong incentives for both payors and payees to classify workers as independent contractors. The lack of a FUTA tax, the absence of withholding obligations and a combined employee-employer FICA tax higher than the SECA tax may tend to result in a shift of questionable workers from the employee to the independent contractor category. However, the risk of reclassification of workers as employees by the IRS and the appurtenant back taxes, penalties and interest may well obviate any incentive for payors to do so.

PRESENT STATUS

The controversy in this area has in large part resulted from increased activity by the Internal Revenue Service's employment tax compliance program. Since the late sixties, the Service has been increasingly aggressive in it attempts to reclassify workers as employees. These reclassifications under audit have an essentially retroactive effect and have peresented many businesses with huge unforeseen back liabilities.

These reclassifications have also threatened the qualification of certain retirement plans. For example, a previously qualified retirement plan could fail to meet maximum coverage requirements if certain workers were reclassified as employees and persons who set up self employed (H.R. 10) palns could find those pland disqualified.

This increased activity by the IRS has been the prime reason for a series of interim relief provisions, beginning in 1978, under which the Treasury has been prohibited from issuing new regulations or rulings in this area. The most recent such moratorium expires on June 30, 1982. The purpose of this interim relief was to allow the Congress sufficient time to consider a resolution of the independent contractor status controversy.

CLASSIFICATION OF WORKERS

It is important for the committee to segregate the immediate and longer term problems in the independent contractor area. The single most pressing need now is for legislative clarification on the proper classification of workers as either employees or independent contractors. The NAM is concerned that attempts to address important but less critical matters may lessen the chances for passage of the essential guidance on classification. For example, questions fo social security funding, SECA tax rates, and withholding proposals should take a subordinate priority to legislation which will assure payors of some certainty in the employment tax area.

In the absence of legislation providing some measure of employment tax certainty, no company can budget, predict, or price its product with reasonable expectations of what its ultimate tax liability will be. These concerns are even more acute for smaller businesses which do not have the cash reserves or the access to credit of larger firms.

Consequently, the NAM supports the safe harbor provisions of H.R. 6311 introduced by Congressman Gephardt (D-MO) and Congressman Conable (R-NY). The "safe harbor" approach of the bill will allow most companies to predict with a fair degree of certainty what the extent of their employment tax liabilities will be.

The classic incidence of the independent contractor relationship in the manufacturing community is that of the manufacturer's representative. Representatives will usually provide services for several manufacturers, but they will typically stay within related industrial groups. Nearly without exception, the representative will control the hours worked and will not have a principal place of business provided to him by the service recipient. As a result, representatives satisfy the first two of H.R. 6311's five requirements.

While a representative's investment in assets used in connection with the performance of services may in certain instances be less than the substantial amount required, the bill's alternative test of income fluctuation would clearly be satisfied by the standard commission relationship between the manufacturer and his representative.

The existing manufacturer-representative relationship will not be disturbed by H.R. 6311, provided that the parties comply with the fourth requirement of a written contract and notice of tax responsibility. While this new requirement would be something of an administrative burden, it is an acceptable one in order to achieve the certainty and predicatability needed in the withholding and payroll tax areas. NAM sees no problem with the fifth requirement of filing of information returns.

The five part safe harbor test will not identify all independent contractors. Those independent contractors that are not able to achieve that status through the safe harbor approach will still be able to qualify as independent contractors under common law principles. NAM believes that the alternative of classification under common law is an integral part of any solution and should be retained as part of any final legislation.

TAXPAYER COMPLIANCE

H.R. 6311 contains several provisions that are designed to improve compliance among independent contractors. While NAM is encourage by the fact that this legislation seeks to deal with taxpayer compliance without resorting to withholding on independent contractors, we are concerned that the proposed penalties are unduly harsh. The NAM believes that adequate sanctions exist in current law to deal with those service recipients that fail to file information returns. If these sanctions are deemed inadequate, then we suggest a dollar limit on first offenses.

While NAM supports the rationale for increased penalties for multiple offenders, a surcharge for de minimis violations such as incomplete reports and late filings in excessive and punitive. NAM contends further that the sliding scale penalty proposed by this legislation is a complex and inefficient way to deter multiple offenders. A simpler and more effective remedy would be a fixed penalty for multiple offenders.

PROCEDURAL MATTERS

The NAM is vitally concerned about the vast majority of businesses that in good faith and with reasonable cause decided to classify certain workers as independent contractors. Many of these same firms may soon face the reclassification of certain workers as employees and may confront a substantial retroactive assessment. The NAM, therefore, proposes that a specific dollar limit be imposed to prevent large retroactive assessments where a reasonable basis existed for the classification of a worker as an independent contractor. The NAM also believes that there should be taxpayer access to the Tax Court to contest IRS reclassification or to some other judicial forum that does not require the payment of disputed taxes as a pre-condition to litigation.

This concludes my prepared statement with regard to the matter. I would be pleased to address any questions which any members of the Committee may have.

Chairman **Stark**. Mr. Lehr, I do understand that you had a rather severe go-round on the safe harbor classification issue.

Would your concerns be reduced if we eliminate the potentially large retroactive liabilities that might occur in a reclassification?

Mr. **Lehr**. Well, I think that was done, Congressman, with the section 530 of the 1978 law when, for whatever reason, when we were under audit back in 1972, our companies——

Chairman **Stark**. If that expires——

Mr. **Lehr**. No, then we are faced with the same problem we were before.

As the days go by, the tax liabilities come up and the challenge that our people are employees——

Chairman **Stark**. What I am suggesting to you is that we merely eliminate the concern of retroactivity, even though it expires——

Mr. **Lehr**. That wouldn't solve our problem, I don't think, Congressman, because we will still be faced with the issue as to whether or not under provisions of the common law our agents are independent contractors. We are confident they are.

Chairman **Stark**. Until that decision is made, you would have no liability.

Mr. **Lehr**. We may not incur any particular tax liability, but the litigation costs and resolution of the issue through either the Court of Claims, Tax Court, and probably ultimately the Supreme Court, if it goes that far would be costly. The hazard, if an adverse determination is made, would result in far reaching problems, for example, the impact on our agents' HR. 10 program, our corporate pension plan for employees and a myriad of other things. I think, being thrust back into that arena, we are confident, as confident as any lawyer can be as to the outcome of the lawsuit, that we could establish that our agents were independent contractors, but that would take years and cost hundreds and hundreds of thousands of dollars.

There is somewhat of a maxim in the law, there is no case so good that it can't be lost. So the alternative without safe-harbor legislation we don't see as a very good one.

Chairman **Stark**. There is a maxim in legislation, if it ain't broke, don't fix it.

Mr. **Lehr**. I submit, sir, that this is broke.

Chairman **Stark**. Mr. Guarini.

Mr. **Guarini**. I just want to ask one simple question. I assume that nobody really cares about withholding taxes because it is a problem.

Nonetheless, will you just state in your opinion whether or not you feel that the tax compliance would be improved if we did have a withholding of taxes required by the employer, not if you want it, but whether you feel in your own personal opinion that tax compliance would be improved by the device of withholding taxes?

Mr. McHugh?

Mr. **McHugh**. Congressman, you ask a very difficult question.

Mr. **Guarini**. No, it is very simple.

Mr. **McHugh**. No, it is a complex question, Congressman, because if I address simply the direct selling type of activity——

Mr. **Guarini**. From a Treasury viewpoint, would we get, at a time when we need more tax collectibles in our country, greater tax compliance if there were——

Mr. **McHugh**. There is no question, Congressman, that the Treasury, the revenue raising of the Treasury is enhanced by withholding. We could turn over all our money and they would be better off. That doesn't go to whether it should happen.

I understand your question wasn't——

Mr. **Guarini**. Just simply, narrowing the issue, would there be greater tax compliance? I know there could be other parts to the answer, but would tax compliance itself, if we just narrow and focus on that one point, would it be enhanced?

Mr. **McHugh**. Well, based on what I have heard in the testimony this morning where there is 95 percent compliance already, I am not sure the answer is even yes.

Mr. **Guarini**. Then you hedge on saying yes or no, is that correct?

Mr. **McHugh**. I don't have the facts. I would like to say for the record though that I would be opposed to withholding on substantive grounds.

Mr. **Guarini**. All right. Your answer stands on the record.

Mr. Brooks.

Mr. **Brooks**. I am definitely opposed to any form of withholding, sir, and it would be a detriment to my business.

Mr. **Guarini**. That wasn't the question.

The question was whether or not we would enhance our tax collectibles if we did have a withholding. Would there be a higher level of tax compliance, in your opinion?

Mr. BROOKS. In my opinion, I go along with the others. You are getting it now anyway.

Mr. GUARINI. You don't like the question. All right.

Mr. Lehr?

Mr. LEHR. Excuse me.

Mr. YOUNG. Excuse me. I am Steven Young, legislative representative for Manufacturers' Agents National Association.

Mr. GUARINI. Yes, sir.

Mr. YOUNG. I think based on pure statistics among the universe of all independent contractors, you probably would get greater compliance.

Mr. GUARINI. I think that is a frank and fair answer.

Mr. YOUNG. However, that is among the universe of independent contractors. In the manufacturers' agency industry, however, I don't think you will increase your collectibles.

Mr. GUARINI. Why shouldn't there be 100 percent collection as there is 100 percent collection on people who are regular employees in an industry, because they have W-2 forms? Why should we have in our Nation only 56 percent of our capital gains taxes collected according to the Treasury Department reports, because we don't have a complete system of compliance? Why should independent contractors only have 85 to 90 percent compliance?

Mr. YOUNG. Mr. Guarini, it seems to me that the problem lies not necessarily in the independent contractor's sector, but with the Treasury Department's inability to enforce its already established procedures to monitor tax compliance.

Mr. GUARINI. Eighty-five percent is satisfactory as far as you are concerned on tax compliance? On independent contractors, is that a satisfactory level?

Mr. YOUNG. The objective of our voluntary tax system being obviously to collect all necessary taxes on taxable income, it seems to me that the 1099 system, as it exists——

Mr. GUARINI. All right. Mr. Lehr and Mr. Libin, I know I don't want to take too much time. I thank you for your remarks.

Mr. LEHR. Excuse me. Anyone named Gus all his life doesn't deliberately mispronounce other peoples' names. My feeling is that you would get less revenue from the insurance industry in tax dollars by withholding than you do now.

As Mr. Libin has testified, the 1979 study, faulty though it may have been, indicated a very high percentage of compliance of insurance agents paying their taxes through the independent contractor route.

So, to require withholding would be to impose substantial costs on the payor to set up the system to keep the records.

All of these would constitute business expenses, which would lower profits which would reduce taxes on the profits.

Mr. GUARINI. That is true of steel, automobile industry, computers or any other industry.

Mr. LEHR. But where you have as high a compliance as you do already in the insurance industry from agents, you would reduce total tax revenues collected from the total group of people by imposing withholding.

Mr. GUARINI. That is your impression on the insurance industry and you may well be correct. But you must admit different industries will have a different level of compliance and some not as good a track record as others, is that fair?

Mr. LEHR. I am sure it is.

Mr. LIBIN. I would agree with that. As counsel for an insurance association, I would reassert the position I previously stated—insofar as the insurance industry is concerned, there is absolutely no need to impose a withholding system. As a citizen and taxpayer I obviously share your concern about the failure of many people to pay the taxes they owe. The tax gap we hear about is very disturbing and very frustrating to those who comply with the tax laws.

In answer to your question in its broadest form, I would agree that a withholding system would raise more revenue than we are now raising.

Mr. GUARINI. Thank you, sir.

Mr. MCHUGH. Could I come back to the question you asked, Mr. Guarini, why is there a difference between the employee we know today, you, myself and others, versus the independent contractor?

One, the employees of the world can estimate within a reasonable amount of money the income that they will receive for employment through the year and the employer can do the same thing.

The independent contractor cannot. His is a fluctuating income based on his effort and even with that effort, income may not be produced.

Mr. GUARINI. That might be so, Mr. McHugh, but I really don't believe that is the common denominator. We are talking about whether or not the industry wants to withhold, wants to pay social security taxes, whether they want to do the bookkeeping, pay workmen's compensation.

There are a lot of little side answers in addition to the one you just gave.

Mr. MCHUGH. The second one is more telling, though, and that is the individual, the independent contractor, if he buys and sells products, generally has expenses to set off against the income, the so-called income that would be subject to withholding, and it doesn't fall evenly in that case on the independent contractor and the employee. The independent contractor may come out with a zero profit. Hopefully, he won't, but he could, but the employee would not.

Mr. GUARINI. If I work for a steel company and I have to drive to work in the morning, can I take my driving to work in the morning off my income tax?

Mr. MCHUGH. No.

Mr. GUARINI. Could I do it if I were an independent contractor? Multiply that times 100 million or 10 million or whatever it is, and you will see we are talking about big sums of money.

Mr. MCHUGH. But the point is if the person has deductions and he may end up with zero taxable income, what is withholding going to do there? It is an added burden on the industry, in that relationship.

Chairman **Stark**. We are at about the end of our time. I would just like to add a comment to keep all of the attorneys in the room happy. If we have safe harbor legislation, it is inconceivable that there would be no litigation.

Safe harbor is merely a test, and I would be surprised if the Internal Revenue didn't decide to test some of them in the courts.

Before I call the next panel, I would like to yield to my distinguished colleague from Tennessee, the ranking minority member of this subcommittee, to recognize some particularly special guests.

Mr. **Duncan**. Thank you, Mr. Chairman.

I am honored today to have about 50 Methodist young people from my home town of Knoxville, Tenn., in the back of the room.

Chairman **Stark**. We are delighted to have them as guests.

I would like to call our next panel, Miss Grace Ellen Rice, assistant director of the National Affairs Division of the American Farm Bureau Federation; Mr. Kenneth S. Rolston, Jr., president of the American Pulpwood Association; Mr. Michael T. Scanlon, vice president for motor fuels policy of the National Oil Jobbers Council; and Mr. John D. McNeer, former member of the board of the Specialty Advertising Association International. He is accompanied by Mr. Ted Olson, president of the Specialty Advertising Association, and Mr. Malcolm D. MacArthur, general counsel.

Would all of you please sit at the witness table so that we can identify you for the reporter. I will ask you to proceed in the order that you are listed on the witness sheet.

STATEMENT OF GRACE ELLEN RICE, ASSISTANT DIRECTOR, NATIONAL AFFAIRS DIVISION, AMERICAN FARM BUREAU FEDERATION

Ms. **Rice**. Mr. Chairman, my name is Grace Ellen Rice, and I am assistant director of the National Affairs Division of——

Chairman **Stark**. Ms. Rice, could I ask you to get closer to the microphone, they seem to work best if you come as close to swallowing them as possible. Thank you very much.

Ms. **Rice**. My name is Grace Ellen Rice. I am assistant director of the national affairs division of the American Farm Bureau Federation. The Farm Bureau is the Nation's largest general farm organization, representing over 3 million member families in 48 States, and in Puerto Rico.

The Farm Bureau is a voluntary nongovernmental organization, whose policy is developed by Farm Bureau members at the county, State, and national levels.

Farm Bureau commends the subcommittee for holding hearings on legislative proposals concerning the status of independent contractors. The audit campaign of the Internal Revenue Service has been a burden to individuals who must defend their status as independent contractors and those who retain the services of independent contractors.

While Farm Bureau supports the current moratorium on Internal Revenue Service regulatory activity with regard to independent contractors, we believe that Congress should act now to clarify the definition and tax status of independent contractors.

Farmers often use the services of individuals traditionally classified as independent contractors. Independent contractors provide agricultural services during the planting and harvesting of crops and timber. They control their working schedules, own and maintain their equipment, and determine the most appropriate means for performing the task for which they are contracted. To attempt to classify these individuals as employees is an unfair administrative and financial burden to farmers who retain their services.

While independent contractors often provide direct agricultural services to farmers and ranchers, Farm Bureau offers its members economic services such as property, casualty, and life insurance. The insurance sales activities are provided by insurance agents, traditionally considered independent contractors, who control their own working hours, have no principal place of business and who risk fluctuations in income based upon their own initiative.

The efforts of the IRS to reclassify these independent business people as employees, rather than independent contractors, is unwarranted. A change in the classification of individuals who are now classified as independent contractors could have serious consequences on the operations of Farm Bureau-affiliated companies and thus work to the detriment of farmers and ranchers whose businesses are insured through the farmer-owned mutual companies.

Farm Bureau supports legislation such as H.R. 6311 introduced by Representative Gephardt and Representative Conable. We believe that the bill provides objective standards to determine whether an individual is an independent contractor or employee. Provisions relating to control of hours, place of business, investment or income fluctuation, contract and notice, and filing provide clear guidance.

In addition, we believe that the "no inference" clause is important to assure that all individuals who traditionally have been considered independent contractors will continue to be treated as such for Federal tax purposes.

Although the more comprehensive reporting and contract requirements of H.R. 6311 may cause more administrative effort by independent contractors and their service recipients, and the possibility of stronger penalties for failure to comply, the bill does promote a clear definition of who qualifies as an independent contractor.

We urge the subcommittee to approve this legislation. Farm Bureau asks that Congress act promptly to clarify standards for determining independent contractor status. The moratorium has provided temporary relief, but we seek a permanent solution that must be enacted before June 30.

Thank you.

[The prepared statement follows:]

STATEMENT OF GRACE ELLEN RICE, ASSISTANT DIRECTOR OF THE NATIONAL AFFAIRS DIVISION, AMERICAN FARM BUREAU FEDERATION

The American Farm Bureau Federation is the nation's largest general farm organization representing over three million families in 48 states and Puerto Rico. Farm Bureau is a voluntary, nongovernmental organization whose policy is developed by Farm Bureau members at the county, state, and national levels.

At the 62nd annual meeting of the American Farm Bureau Federation, voting delegates of the member State Farm Bureaus adopted the following policy with regard to the classification of independent contractors and employees:

"During the last several years the Internal Revenue Service has attempted to change several taxpayer classifications from independent contractor to employee. This group includes custom harvesters, carpenters, truck drivers, insurance agents, realtors, and other individuals traditionally considered independent contractors.

"Congress has acted to continue the present definition of independent contractors through June 30, 1982. We recommend that the present independent contractor status of the affected individual be preserved."

Farm Bureau commends the Subcommittee for holding hearings on legislative proposals concerning the status of independent contractors. The audit campaign of the Internal Revenue Service has been a burden to individuals who must defend their status as independent contractors and those who retain the services of independent contractors. While Farm Bureau supports the current moratorium on Internal Revenue Service regulatory activity with regard to independent contractors, we believe that Congress should act now to clarify the definition and tax status of independent contractors.

Farmers often use the services of individuals traditionally classified as independent contractors. Independent contractors provide agricultural services during the planting and harvesting of crops and timber. They control their working schedules, own and maintain their equipment, and determine the most appropriate means for performing the task for which they are contracted. To attempt to classify these individuals as employees is an unfair administrative and financial burden to farmers who retain their services.

While independent contractors often provide direct agricultural services to farmers and ranchers, Farm Bureau offers its members economic services such as property, casualty, and life insurance. The insurance sales activities are provided by insurance agents, traditionally considered independent contractors, who control their own working hours, have no principal place of business and who risk fluctuations in income based upon their own initiative. The efforts of the IRS to re-classify these independent business people as employees, rather than independent contractors, is unwarranted. A change in the classification of individuals who are now classified as independent contractors could have serious consequences on the operations of Farm Bureau-affiliated companies and thus work to the detriment of farmers and ranchers whose businesses are insured through the farmer-owned mutual companies.

Farm Bureau supports legislation such as H.R. 6311 introduced by Representative Gephardt. The bill provides objective standards to determine whether an individual is an independent contractor or employee. Provisions relating to control of hours, place of business, investment or income fluctuation, contract and notice, and filing provide clear guidance. In addition, we believe that the "no inference" clause is important to assure that all individuals who traditionally have been considered independent contractors will continue to be treated as such for federal tax purposes. Although the more comprehensive reporting and contract requirements of H.R. 6311 may cause more administrative effort by independent contractors and their service recipients the bill does promote a clear definition of who qualifies as an independent contractor.

We urge the Subcommittee to approve. Farm Bureau asks that Congress act promptly to clarify standards for determining independent contractor status. The moratorium has provided temporary relief, but a permanent solution must be enacted before June 30, 1982. Thank you.

Chairman STARK. Mr. Rolston.

STATEMENT OF KENNETH S. ROLSTON, JR., PRESIDENT, AMERICAN PULPWOOD ASSOCIATION

Mr. ROLSTON. I am with the American Pulpwood Association and I am here to represent logging contractors. One of the problems we have when we represent logging contractors is that quite often you think of Paul Bunyan or Babe, the blue ox, somebody that drives up in your front yard with some firewood to sell, or someone clearing a subdivision, that sort of thing. That is not what independent logging contractors are. My pardon to Mr. Duncan, because I know he knows what logging contractors are.

What they are are people with a lot of hustle and muscle out in the forested region that have to invest capital in logging equipment. It is very expensive logging equipment. They hire two or three employees. They go out and negotiate with landowners for the right to cut their timber or bargain for their logging services and they cut the trees and haul them out of the forest, and of course it is a unique situation.

It is one of the few occupations where you destroy your workplace every day, if you are successful. If you don't, you are not successful. You have to move the trees out of the forest. These logging contractors are just about as independent as you can get.

Chairman STARK. Particularly when you see them coming down the highway with big rigs loaded with logs.

Mr. ROLSTON. That is right. Stay over on your side of the road, Mr. Chairman.

In fact, efforts to try to create an employment relationship for a logging contractor are just going to be futile. He is not going to be an employee. He is that type of person. Logging does not lend itself to large-sale enterprise. It is way off in remote regions. You just can't get this whole corporate structure out there gathered around some trees, and have successful logging. They try it in the Soviet Union and they do it terribly.

There have been some suggestions to solve this whole situation for logging contractors. I certainly hope I don't have to go back to my members and say: Hey, the solution is let's let the moratorium expire, and let's rely on the wisdom, the kindness, the compassion of the Internal Revenue Service.

We have been through this for a long time, and I would particularly like you to, if you have a chance, look at the transcript of a radio program that Mr. Reagan, now our President, presented concerning one of our IRS cases. It's in our written submission when I hear IRS and Treasury people say they are interested in tax compliance, the case President Reagan cited comes to mind. This case in Vermont was a small logging business man harassed by the IRS. The IRS was not interested in seeing the tax returns of the contractors involved. The taxes were all being paid. The IRS wasn't interested. They are interested in fostering an unwanted employee relationship. That is why we are very anxious to have some kind of a safe harbor, and the kind that we like is the one that is expressed in H.R. 6311.

Incidentally, the IRS has never won an employment tax case in logging in court. That leads to what the real problem is and why we need the safe harbor. The real problem is the cost of litigation, and what it does to you personally. I am not just talking about the loss of sleep, worry, and the attorney's expense. Here is somebody like all small businessmen that operates on credit. My banker finds out I am not a small businessman. The Internal Revenue Service says I am an employee. Away goes your credit until this whole thing is straightened out. It is really a difficult situation.

The other suggestion was to eliminate or reduce the retroactive assessment. In other words, let's not have that many bucks down the line. That doesn't address the problem of how am I going to hang onto my credit; what are very legal costs, or am I really in business for myself?

The issue of needing safe harbor, I believe, and our people in the logging business believe, has one very important factor that goes with it that very seldom gets addressed.

Logging contractors want to stay at peace with their government. In order to do that, they have to have something they can understand as to what is an independent contractor and what is an employee. Getting that safe harbor in the law, I believe, is going to restore the confidence of these small businessmen in their government.

Thank you very much.

Chairman STARK. Thank you very much.

[The prepared statement follows:]

STATEMENT OF KENNETH S. ROLSTON, JR., PRESIDENT, THE AMERICAN PULPWOOD ASSOCIATION

SUMMARY OF COMMENTS AND RECOMMENDATIONS

* The American Pulpwood Association commends the Subcommittee on Select Revenue Measures for its current undertaking - resolution of the central issue of who is or is not an independent contractor for purposes of federal employment tax obligations.

* We fully support consideration of methods to enhance taxpayer compliance. However, we aver that taxpayer compliance cannot and will not be enhanced unless compliance is realistically addressed as a component of the larger and more significant issue - clarification of the proper taxpayer.

* Logging and pulpwood contractors support H.R. 6311, the Independent Contractor Tax Classification and Compliance Act of 1982, because its safe harbor and compliance provisions represent the comprehensive, not piecemeal, approach that is necessary for a realistic, meaningful, and workable solution.

* H.R. 6311 will preserve the traditional independent business relationships in the logging industry that were recognized in law and by the Internal Revenue Service prior to and during the time of the Service's reclassification effort.

* H.R. 6311's retention of the common law as the appropriate test for relationships outside of the safe harbors provides for equitable determinations with respect to the individually negotiated logging industry agreements which do not qualify under H.R. 6311's safe harbors.

* The vast majority of independent businessmen are in compliance with the tax laws, as reflected in the GAO Report to the Joint Committee on Taxation, Tax Treatment of Employees and Self-Employed Persons, November 21, 1977 (GGD-77-99).

* We urge affirmative action on H.R. 6311 now. If, and only if, H.R. 6311 is not enacted we urge that Section 530 be extended. To do otherwise would again subject viable independent businessmen to arbitrary and unmerited IRS enforcement.

* We know through communication with various IRS offices that the employment tax laws can be properly enforced, and we believe they should be.

- We are certain that in our industry education is the major ingredient in working toward full compliance. APA has a long and worthy record in this field, and we pledge to continue to play an active role in informing all in our industry about their tax obligations.

- H.R. 6311 is the solution to the real problem: independent contractor status. We support measures to improve reporting. We will do our best to continue to help our industry stay at peace with its government.

- We support the intent of H.R. 6300, the Tax Compliance Act of 1982, hearings on which were held before the House Ways and Means Committee on May 18, 1982. However, H.R. 6300's piecemeal approach - attempting to enhance compliance without addressing the substantive issue (taxpayer clarification) - plus its discriminatory and unworkable reporting provisions will ultimately prove fatal to its effectiveness.

- APA would support legislation similar in intent to H.R. 6300 should such legislation incorporate all the provisions of H.R. 6311 as they relate to independent contractors including reporting obligations, as outlined in H.R. 6311, of those with whom independent contractors do business.

- APA opposes H.R. 5867. It is not only a totally unrealistic and unworkable solution, but its withholding consequences will ultimately prove fatal to the small capital-intensive businessman.

INTRODUCTION

I am Ken Rolston, President of the American Pulpwood Association (APA). APA represents both producers and consumers of pulpwood in the United States. Pulpwood is the essential raw material used in the manufacture of pulp and paper products, one of the nation's largest and most productive industries. Our membership includes not only those businessmen and firms that the Internal Revenue Service (IRS) in past years has alleged are new "employers," but also the businessmen and firms that were unwillingly reclassified by the IRS as "employees."

APA's members are vitally interested in the legislative proposals being considered here today. An important part of APA's membership is the independent small businessman who manages, operates, and heavily invests in forestry equipment and machinery. Many of these capital-intensive businessmen, the vast majority of whom have employees of their own, found themselves "stripped" of their status as independent businessmen because of the enforcement policies of the IRS. Although the dollar effect of assessments frequently rested upon one of the purchasers of the contractor's products or services, the effect of each assessment was no less devastating to the logging or pulpwood contractor. Access to capital sources diminished when financial institutions learned that a governmental agency was challenging their status as independent businessmen. Carefully planned retirement programs were suddenly open to challenge. Agreements with other purchasers and access to other forest products markets were jeopardized. Some purchasers refused to do business with or to continue to do business with logging and pulpwood contractors allegedly "employed" by another purchaser, especially in those circumstances in which the purchasers were competitors.

The foregoing should bring into focus the central issue that must be properly addressed: Who is an independent contractor for tax purposes? Businessmen, both buyers and sellers, cannot operate in a situation similar to that of Damocles, the courtier of ancient Syracuse who reportedly was seated at a royal banquet beneath a sword suspended by a single hair.

OUR POSITION

We fully support the legislation introduced by Representative Gephardt, H.R. 6311. We believe it is in the best interests of this nation to maintain and enhance the legitimate, longstanding, and traditional business relationships existing in the logging industry. We aver that H.R. 6311 is an equitable means to accomplish that objective. The following 50 organizations, which represent logging contractors and other forestry and forest industry interests in at least 34 states, join with APA in support of H.R. 6311.

Alabama Forestry Association
Alaska Loggers Association
Appalachian Hardwood Manufacturers Association
Arkansas Forestry Association
Associated Logging Contractors Inc.
Associated Oregon Loggers
California Forest Protective Association
Connecticut Wood Producers Association
Empire State Forest Products Association
Florida Forestry Association
Forest Farmers Association
Georgia Forestry Association
Kentucky Forest Industries Association
Louisiana Forestry Association
Maine Forest Products Council
Maryland Forest Association
Massachusetts Wood Producers Association
Michigan Association of Timbermen
Minnesota Timber Producers Association
Mississippi Forestry Association

Missouri Forest Products Association
Montana Logging Association
Montana Wood Products Association
New Hampshire Timberland Owners Association
North Carolina Forestry Association
Northeastern Loggers Association
Northeastern Lumber Manufacturers Association, Inc.
Northern Hardwood & Pine Manufacturers Association
Northern Woods Logging Association
Ohio Forestry Association
Oklahoma Forestry Association
Oregon Log Truckers Association
Pennsylvania Forestry Association
Rhode Island Wood Operators Association
South Carolina Forestry Association
Southeastern Lumber Manufacturers Association
Southern Forest Institute
Southern Forest Products Association
Southern Hardwood Lumber Manufacturers Association
Southern Oregon Timber Industries Association
Tennessee Forestry Association
Texas Forestry Association
Timber Operations Council
Timber Producers Association of Michigan & Wisconsin
Vermont Timber Truckers and Producers Association
Virginia Forestry Association
Washington Contract Loggers Association
Washington Log Truckers Conference
West Virginia Forests Inc.
Wisconsin Paper Council

SUPPORT FOR THE COMMON LAW AND THE NEED FOR A PROPER LEGISLATIVE SOLUTION

A major part of our support for H.R. 6311 is based upon the fact that it does not supplant the traditional common law test. It is possible that the negotiated terms of some independent contractor relationships in our industry and others will not meet all of H.R. 6311's requirements - yet, in the real world, the relationship is truly independent when its totality is objectively judged under the common law rule.

With this important point in mind, it is useful to review the history of employment status determinations for federal tax purposes and Internal Revenue Service (IRS) enforcement, a history which demonstrates why we are here today and why a proper legislative solution is imperative.

The Common Law and Employment Status Determinations

The Tax Code's definition of employment, as originally enacted by Congress, left the employee/independent contractor issue vague. Not surprisingly, the issue had to be judicially resolved. In a number of decisions the Supreme Court stated that a new doctrine, the "doctrine of economic reality" was the test Congress intended be used to determine employment tax obligations. This determination seriously threatened traditional independent contractor relationships.

In 1948, Congress explicitly rejected the Supreme Court's "economic reality" interpretation, thereby preventing the adoption of IRS regulations that could have converted independent businessmen doing a significant volume of business with one firm into that firm's employees. (Gearhart Resolution, H.J. Res. 296, P.L. 642, 80th Cong., 2d. Sess., Ch. 468, 62 Stat. 438 (1948); 2 U.S. Code Cong. Serv. 2501, 2501 (1948).) The rejection was the result of two concerns: first, overexpansion of the Social Security system; second, having an individual's or organization's status as independent contractor or employee rest on an "unworkably vague" definition. The Congressional wisdom in avoiding an "unworkably vague" definition remains as astute today as it was in 1948.

From 1948 until the enactment of Section 530 "interim relief" in 1978, the IRS applied its test of who is an employee with strong economic reality bias - in effect, rejecting the Congressional mandate. The result has been chaos. IRS' deliberate and continued rejection of the Congressional definition is the main cause of the constant and unnecessary controversy and tension in this area. The problem was not and never has been the common law test of employee/independent contractor, but rather the refusal of the Executive Branch to accept the mandate of the Legislative Branch.

The common law continues to have meaningful application to today's question and tax issues generally. The common law test is flexible. We recognize that this flexibility may produce a slightly irregular pattern as new industries and business relationships arise. It is this flexibility, however, which permits the common law test to judge meaningfully and predictably the nature of the relationship between parties in new economic situations. An additional attribute of the common law test, that is not merely desirable but essential in most tax matters, is its neutrality. In a dynamic, free-enterprise economy it would be tragic to have the tax code impair or interfere with the decision-making process between and among business parties. APA would not support any legislation that replaces the common law test as the appropriate test for determining employment tax obligations.

IRS Enforcement

Employment tax cases can not be brought in Tax Court. The taxpayer must pay the assessment or an agreed percentage of it in advance and bring suit for a refund. Actual assessments contained not only the "usual" assessment, uncollected withholding, Social Security, and unemployment taxes, plus penalties and interest, but also disallowed contributions to otherwise qualified pension plans and challenged individual retirement programs. Essentially, assessments could and did exceed the capitalization of many taxpayers, large and small alike. This, coupled with the intransigence on the part of the IRS in allowing a taxpayer access to court without paying the entire assessment or purchasing a bond for the entire assessment (a radical departure from previous policy), essentially forced individuals and firms either to go out of business by administrative fiat with no judicial recourse, or to simply succumb to the IRS view.

Note should also be made that IRS enforcement actions were predominantly undertaken in instances in which virtually all prior judicial precedents and revenue rulings uniformly held that the individuals, suddenly alleged to be employees, were independent contractors.

Prior Congressional Action

Congress remedied the situation temporarily by enactment of Section 530 of the Revenue Act of 1978 (P.L. 95-600). This relief was subsequently extended twice (P.L. 96-167 and P.L. 96-541) and expires June 30, 1982.

In the 96th Congress in 1979, Representative Gephardt introduced H.R. 3245, substantive legislation designed to solve the real problem: who is or is not an independent contractor. Representative Gephardt's realistic solution was rejected.

A substantive solution is now imperative. If Section 530 lapses without such a solution, independent businessmen will again be subject to harassment by the IRS with no realistic means of defense.

THE MERITS OF H.R. 6311

H.R. 6311, introduced by Representative Gephardt and co-sponsored by Representatives Conable, Holland, Heftel, Hance, and Duncan, is a positive and realistic long-term solution to what was misdirected and unmerited IRS enforcement activity that resulted in unnecessary, vexing, and troublesome problems for many years before the enactment of Section 530. H.R. 6311 clarifies for logging businessmen and for the IRS, on a meaningful and substantive basis, who is or is not an independent contractor. It thus clarifies tax obligations, provides for predictable and equitable enforcement of all the tax laws, and does not disrupt decades of tax status development. Ultimately, H.R. 6311 will curtail the unnecessary expenditure of funds to resolve status disputes, improve reporting, and most importantly, enhance voluntary compliance with respect to tax obligations.

As we have noted, IRS enforcement prior to the enactment of Section 530 reflected an unauthorized and unilateral revision of the definition of and distinctions between an "employee" and an "independent contractor." Because APA members voiced serious concern with the employment tax audits and assessments affecting them, we researched, in-depth, the "right to control" test, the proper statutory basis for determining employment tax obligations. After exhaustive analysis of the 20 criteria used by the IRS as theoretically indicative of the right to control, we concluded that the tests enumerated in H.R. 6311 are the most meaningful criteria that could have been chosen.

The first three tests of H.R. 6311 state the factual situations in a business relationship that must exist before an independent contractor and a payor are recognized as separate, viable, independent business entities. The tests are tough, and embody the essence of being an independent businessman. The basic questions are, and always have been, "Do you, Mr. Businessman, run your own show?" and "Are you, Mr. Businessman, subject to the risks of the marketplace?" and "Mr. Businessman, if you require and are using a principal place of business, are you paying for it?" Because H.R. 6311's criteria embody the essence of what it means to be a proprietor of a business, we consider it impossible for any self-employed businessman to simultaneously fulfill H.R. 6311's substantive requirements and yet be an employee under the common law rule. The criteria, therefore, are not subject to manipulation or abuse.

A further significant benefit of H.R. 6311 is enhanced tax compliance. It is axiomatic that before any individual can comply with tax obligations, he must have some reasonable basis for determining the nature of those obligations. H.R. 6311's first three criteria provide a clear and predictable mechanism for determining status in a business relationship - and therefore knowing one's tax obligations. Control of hours worked and of the scheduling of those hours, principal place of business, if any, and risk of income fluctuation or, alternatively, substantial investment in tangible assets, in addition to being truly indicative of owning a business, can be readily determined. They provide an intelligent and predictable basis for decision.

Tax compliance is further enhanced through the remaining two safe harbor requirements and the new graduated penalties for inaccurate information reporting. The H.R. 6311 requirements of a written agreement delineating the actual relationship between the parties along with their corresponding tax obligations and complete compliance with existing IRS regulations concerning information returns are an affirmative action tax plan. These two provisions alone will enhance voluntary compliance and ease enforcement problems. When further supplemented with the provisions designed to improve and assure greater accuracy in information reporting, enhanced compliance is virtually assured.

In summary, H.R. 6311 answers what has been and must be recognized as the fundamental question: who is or is not an independent contractor? It answers that question on a basis that is not only consistent with business realities but also consistent with equitable enforcement of and improved voluntary compliance with tax obligations. Further, H.R. 6311's safe harbor will enable the IRS to guide its enforcement efforts to the correct port - the properly identified non-complying taxpayer. The senseless drift of those resources and their utilization in protracted, unwarranted, unnecessary, and unproductive litigation to simply identify the taxpayer (properly a legislative matter) will finally end.

We support the provisions of H.R. 6311 which develop a new penalty system to improve the accuracy of information reporting on payments to independent contractors by service recipients. We have been advising our members of the benefits to them and to the government of strict compliance with Sec. 6041A for many years. Providing accurate data to the IRS concerning the identification of taxpayers and the amounts paid coupled with matching of payments with returns will provide the most effective and efficient means to stimulate improved compliance.

PROCEDURAL ISSUES

H.R. 6311 will not solve all of the problems associated with IRS employment tax audits. It will solve the major problems which our industry has encountered by preserving the status of most traditional relationships that heretofore were recognized by the courts and the IRS as independent.

For those relationships in logging which will have to rely on the common law tests, the difficulties associated with retroactive assessment and access to the courts remain. The question of retroactivity should be reexamined in instances in which service recipients have properly filed information returns. We also feel that these cases should have access to the Tax Court.

However, we do not recommend that these procedural issues be addressed now. The time is short for enactment of H.R. 6311 before Section 530 relief expires on June 30. Remaining issues can be addressed later, when and if they become problems.

NO RETURN TO PAST PRACTICES

Section 530 ended a nightmare for many in our industry faced with mounting legal expenses and, in some cases, difficulty in obtaining capital financing because of undecided status. If Section 530 were permitted to lapse without enactment of the long term solution represented by H.R. 6311, we are certain that the IRS would resume its improper enforcement activity and return to its previous misapplication of the economic reality test. That must not be permitted. It is appropriate to read the text of a radio broadcast concerning an APA member who previously appeared before this subcommittee on this issue. The broadcast is entitled "Independents vs. IRS," and was delivered February 23, 1978 by the man who is now our President, Ronald Reagan.

> Reginald Dwyer is one of a rare breed, an independent Vermont logger. Even in subzero weather you can find Reg Dwyer out in the woods, bringing out pulpwood to feed the nation's huge appetite for paper products. And, after a hard day in the woods, you may find him at the school board meeting in his little town of Sheffield. Reg is one of those dependable, community-minded small businessmen who have done so much, over two centuries, to create the image of Vermont in the national mind.

But Reg Dwyer is in trouble - $18,500 worth of trouble - with the Internal Revenue Service. It's not about paying his taxes - he's always done that. It's about paying other people's taxes. To understand why the IRS is hounding him and dozens of other small logging contractors in New England and the deep South, it's necessary to know how an independent logging operation works.

Most of the pulpwood produced by independent loggers in the Northeast is produced on what is called the contract system. The prime contractor - a man like Reg Dwyer - secures stumpage or cutting rights. Then four operations follow in sequence: felling and limbing the trees, skidding the logs to a collection yard, cutting the logs to pulpwood size, and loading and trucking the wood to the paper mill. Sometimes, in large operations, one company will hire employees to perform these various operations. But, in independent logging, each operation may be performed by a specialist who works on contract with the prime contractor. Fellers and cutters provide their own chain saws, fuel, safety equipment, and transportation to the job. The skidder may own his own bulldozer or skidder to haul the logs out of the woods. The trucker will own his own truck with an expensive clamshell loader.

Now, all these subcontractors are in business for themselves. They may work for many different logging contractors over the year. But the IRS has traditionally been hostile to this independent business system because it makes it more difficult for it to track down and tax every dollar of income. Self-employed persons pay less than employees to social security. And they may deduct up to five times as much in self-employed retirement plans as employees.

So the IRS informed the Dwyers - by announcing it to them before their neighbors in the lobby of the Sheffield post office - that they owe Uncle Sam $18,500 in social security, withholding, unemployment insurance taxes, penalties and interest for all the independent subcontractors they have contracted with over the past five years--whether or not those subcontractors have already paid the required taxes! And if the Dwyers have to pay, it will darn near put them out of business.

New England's independent loggers are not the only victims of this IRS attack. Independent contractors of all kinds--artisans, truckers, taxicab operators, repairmen, and fishermen are under the same gun (although Congress exempted certain lobstermen by statute in 1976). It's time that Congress told the IRS loud and clear, that the independent small contractor is a vital part of America. They cannot survive if, in addition to the risks of the economy, they are harassed into insolvency by an IRS determined to make them pay the taxes of others with whom they contract, as well as their own.

APA'S TRADITIONAL CONCERN FOR TAX COMPLIANCE AND THE ORIGINAL COMPLIANCE STUDY

The reputations of many independent contractors have been unnecessarily and wrongfully sullied because of IRS assessments and allegations. In a reputable study concerning contractor compliance (General Accounting Office, Tax Treatment of Employees and Self-Employed Persons, November 21, 1977, GGD-77-99), the GAO concluded that "those taxpayers involved in employee/self-employed redeterminations had generally paid their income and social security taxes" (p. 24). This finding was predicated upon IRS data from the Taxpayer Compliance Measurement Program which indicated that independent contractors reported 96.7% of their gross receipts.

APA believes it is partly responsible for this excellent record and further believes that it can be improved upon. We also know that the employment tax laws can be enforced. We know that independent contractors can be found, their tax obligations determined, appropriate action taken, and the level of voluntary compliance enhanced if the correct problem is addressed and the correct solution applied.

A letter from an IRS office suggests a way APA could assist IRS in its mission of achieving voluntary compliance:

> (Develop) a continuing education program to make pulpwooders fully aware of their federal tax obligations, both business and personal.

APA has a continuing record of tax law compliance education dating back to the mid-1960s. Most recently, over a two year period (1976-1977), in cooperation with the IRS and the Social Security Administration, APA carried out an extensive information and education program, including the production of two films, to help logging businessmen know their proper tax obligations. The effort involved hundreds of meetings on virtually a county-by-county basis in numerous forested states, and reached over 20,000 people. We know this joint effort generated a greatly improved understanding of complex tax law requirements and improved the level of compliance.

Our education efforts continue both at the field level and through distribution of our landmark 145-page publication, How to Stay at Peace With Your Government, which has been through six revisions and has been broadened to include vital information on all federal laws and general information on state laws affecting employers. We intend to continue these educational efforts.

We firmly believe that small logger businessmen want to fulfill their obligations to government and that they will do so if they know what is required.

We began our comments concerning APA's continuing efforts to enhance tax compliance by noting that the reputations of many independent contractors have been unnecessarily and wrongfully sullied. An action that contributed significantly to the notion that law-abiding independent contractors were not meeting their tax obligations was the Treasury Department Study concerning tax compliance presented at the July 16, 1979 hearings of this subcommittee. The study concluded with the proposal that withholding be instituted on payments to independent contractors. That study has been repeatedly referred to by IRS officials as indicative of the problem to be solved. All objective analyses have reached identical conclusions: The study is tragically flawed and does not prove that which it purports to prove; its conclusions are totally contradicted by independent governmental studies in which an agency did not have an "axe to grind;" and at minimum, the study should not be used as the basis for any substantive policy action. APA submitted to this subcommittee in earlier hearings a detailed analysis of the IRS study as it relates to logging. We would be pleased to provide copies of our comments upon request.

THE "TAX COMPLIANCE ACT OF 1982," A BILL THAT MUST FAIL IN ITS ESSENTIAL PURPOSE

It has long been APA's position that all should comply with their tax obligations. We consider the current Congressional consideration of appropriate mechanisms to enhance tax compliance a laudatory effort. For Congress to do otherwise is to simply countenance fraud. The long-term implications of such an unstated policy augers ill for all voluntary compliance with the tax laws and ultimately augers ill for the health of this Republic.

Unfortunately, one of the efforts to enhance compliance, the "Tax Compliance Act of 1982" (H.R. 6300), hearings upon which were held before the House Committee on Ways and Means on May 18, 1982, is tragically flawed. It represents a piecemeal approach to an issue that requires a comprehensive analysis and solution. Such a piecemeal and unbalanced approach dooms a significant portion of H.R. 6300 to failure.

We began by noting our position - all should comply with their tax obligations. Yet, the matter at issue here today and which was at issue until enactment of Section 530 because of biased IRS enforcement, was the precise question of identifying the proper taxpayer so that tax obligations are predictable and definite. It should be axiomatic to any resolution of the compliance issue that before any taxpayer can voluntarily comply with his tax obligations, he must know those obligations. To leave unresolved the status issue in any compliance measure is to leave unresolved the basic mechanism through which voluntary compliance is enhanced - predictability and clarity with respect to tax obligations.

This is one of the few instances in which half a loaf is not better than none. In actual practice, it will ultimately represent an instance in which half a loaf will be worse than none. All affected industries will incur significant new burdens with their concommitant expenses - all deductible. The government will receive reams of information, a significant portion of which will be utterly useless in its determination of a taxpayer's actual tax liability. There will be significant expense to the government simply for receiving and processing all the additional forms and information. Yet, through it all, it remains problematical that collections will be enhanced. As noted in expert testimony during the May 18, 1982 hearings, taxpayers will receive forms of limited utility in calculating their tax liability. Taxpayers may come to distrust all "official forms," and ultimately there may result a presumption of inaccuracy even with respect to the heart of the tax compliance system - Form W-2 reporting wages.*

A sensible solution exists. H.R. 6300 can be an effective vehicle to foster tax compliance if it is amended to include all the provisions of H.R. 6311 - the safe harbors as they relate to proper classification and the reporting provisions as they relate to the obligations of service-recipients.

H.R. 5867 - THE DEMISE OF THE CAPITAL-INTENSIVE SMALL BUSINESSMAN

The implications of H.R. 5867 must be analyzed in the light of the economic setting in which an affected industry operates. For this reason, we begin our analysis with some brief background information on our industry.

---

*Statement of Alexander Zakupowsky, Jr. on behalf of Deloitte, Haskins, & Sells before the Committee on Ways and Means regarding the Tax Compliance Act of 1982 (H.R. 6300), dated May 18, 1982.

Background

Logging is unique in terms of its capital equipment requirements. The type and quantity of capital expenditure may vary considerably by region. For example, logging equipment required in the northwest United States, given the terrain and sheer size of standing timber, may vary considerably from that required in the southeastern coastal plains. However, even given the variances in capital equipment mix, one absolute truth covers logging and pulpwood operations - heavy equipment is essential to the performance of the service, and all such equipment is extremely expensive.

Most contracts are negotiated on a delivered basis. Therefore, the contractor must have available all of the equipment necessary to fell the trees, transport them within the forest, load them from a point within the forest to on-the-road equipment, and finally transport them over the road to the delivery point. This "snapshot" is a picture of the type of logging and pulpwood contractor APA is seeking to protect against future arguments concerning his status as an independent businessman.

It should also be noted that the products produced by APA members are essentially raw materials, not final products in and of themselves. Consequently, the demand for the service and therefore its value is derived. For example, the sharp and prolonged downturn in housing has had a significant negative effect upon the demand for and value of the services of logging contractors. Recent published reports reflect a significant downturn in the demand for paper products. Contractors for pulpwood are presently experiencing a scenario very similar to that experienced by contractors whose predominant business operations were geared to raw materials used in the housing industry.

The foregoing amply demonstrates that logging is a series of financial variables. The price for the service is a variable and is derived from demand in end-use markets. Fuel, lubricants, wages paid, interest on capital financing, repairs, operating conditions (terrain, tree size, weather), equipment - all are costs and all are variables. They are variables with high velocity. The recent events in fuel prices and interest rates attest to that premise. Therefore, a logger's return (income) on sales, either product or service, is a variable and an unpredictable variable.

With the foregoing as background, we will begin the analysis of the impact of H.R. 5867 on the businessmen in our industry. We believe, however, that the comments that follow can be applied generally to all capital-intensive small businessmen.

Place of Business, Assets, or Sales

H.R. 5867 poses two distinct problems for capital-intensive small businessmen. First is the proposed statutory wording of the safe harbors per se. Second is the statutory structure of the safe harbors; that is, risk of income fluctuation and assets as separate and distinct requirements.

The problematical provision is the safe harbor titled "Place of Business, Assets, or Sales." The third alternative of that safe harbor requirement, "Sales," is obviously inapplicable, as it encompasses only those individuals and occupations specifically identified. Therefore, unless a capital-intensive small business has a principal place of business, or, in instances where it may be otherwise unnecessary, either creates one and carries the associated overhead burdens or realigns a personal residence, the business must rely on the alternative headed "Tangible Property Furnished by Individual." We will concentrate on this alternative because it was the provision intended for those who perform services using a significant asset base.

The Asset Alternative - A Fundamentally Unsound Thesis

The H.R. 5867 asset alternative states that its requirements are fulfilled when, "In general. -More than one-third of the value of the service is attributable to tangible property furnished by the individual performing the service."

It is fundamentally flawed!

The alternative states a proposition that is incapable of proof, and the burden of proof is on the taxpayer. It literally requires, regardless of any stated percentage, that a capital-intensive businessman prove that there exists a value for his service because assets are used in its performance. When originally proposed, we conferred with those knowledgeable in economics as to the impact of the alternative. It was simply stated that the alternative placed the known world of contemporary economic thought on its head. It is extremely doubtful that any economic expert would testify that value of any service or product is derived from or attributable to the fact that assets are employed in the rendition or manufacture of the service or product. The "real world" is simply the opposite. It is the fact that there exists a market for a service, and the corresponding value the market attributes to the service, that determines whether or not (1) any investment in assets will be made by any individual, (2) the amount of the investment any individual will make, and (3) the degree of utilization of the investment property after the investment has been made. In the current economic climate, there are numerous assets being underused or unused. If the value of their production, service, or product were simply "attributable" to the asset, such would not be the case.

One gets the impression that the drafters of the asset alternative in H.R. 5867 lost sight of the direction of the causality. Two facts occur simultaneously - an investment in assets and a value for the services. It was then assumed that the value of the service was "attributable" to the fact that assets were used in its performance A simple analogy highlights the speciousness of that conceptual framework. Every morning the sun rises. Every morning the birds sing. Two events occur simultaneously. No one would argue that singing birds cause the sun to come up, or that the rising of the sun is attributable to singing birds. However, such is the precise thesis of the asset alternative. Cause and effect are misstated. The fact that an investment asset exists is attributable to the value the market will pay for the service, not vice versa. If the value did not exist, no investment would be made. When the value ceases to exist, those in the business face bankruptcy.

Unfortunately, the investment outlook in logging today is glum. APA can assure you that the current bleak outlook is not a product of the fact that the depressed market value of the services rendered by our members is determined by or attributable to their substantial asset base.

Investment Return as a Method to Measure Value Attributable to Assets

If it is assumed that the asset alternative is viable, much of what was apparently intended was stated in Part II Explanation of H.R. 5460 of then Subcommittee Chairman

Rostenkowski's Transmittal Letter to then Chairman Ullman, dated December 13, 1979. With respect to the asset alternative, it states:

> "Methods for determining and allocating the value of the service (attributable to tangible property) might include but would not be limited to, a comparison of the remuneration paid to the worker with the investment return that could be expected on the amount of tangible property furnished by the individual, or a comparison of the remuneration paid by a worker who performs the same services but furnishes no tangible property." (Emphasis supplied.)

After publication of the transmittal letter, APA began an analysis of the largest industrial corporations to determine the return on assets for each. Fundamental questions were put aside, for example, the value to assign to the assets (replacement value,* actual cash value, historical cost, depreciated value for the tax year in question). The results were so obvious that the project was discontinued after approximately 200 companies were examined. Not one had a return on assets of 33 1/3%. Plain common sense dictates a similar result. If there existed an investment with a return of 33 1/3%, who in the United States or the free world would invest in anything else? Returns of that magnitude are not consistent with the concept of investment or the operation and management of a business. On Wall Street and in other financial circles generally, returns of that magnitude are called "sheer speculation."

The H.R. 5867 asset alternative is economically flawed. As the foregoing demonstrates, APA would consider reliance upon it by APA members dangerous. Ultimately its effect, should return on investment become a controlling measure, may actually serve to penalize those who invest heavily in tangible assets. The requirement of a 33 1/3% return is consistent with speculation, not investment. Sophisticated accounting and service-recipient financing may be encouraged because of its favorable impact upon the return on assets to be considered for purposes of the test. A basic question remains - if the touchstone of the alternative is the value of the services, why should independent contractor status be a function of the market price of the services for the tax year in question? The net result will prove to be inconsistency from tax year to tax year. In tax years of high demand and consequent high value, the contractor may be insulated from attack. During tax years of low demand and diminished value, i.e., years involving high risk of loss and requiring considerable entrepreneurial and managerial skill, the contractor is exposed to attack upon his status as an independent businessman. Is not the free enterprise system turned on its end?

---

*When adjusted for inflation, many corporations' financial statements are presently showing negative returns.

Place of Business Alternative

Because reliance on the H.R. 5867 asset alternative is ill-advised, capital-intensive small businessmen, to protect their status as independent contractors from attack under this bill, would be wise to rely upon the "Place of Business" alternative. For many, that is an absurd choice. All logging contractor operations are conducted in the forest. There is constant movement of men and equipment from timber tract to timber tract. Bookkeeping, recordkeeping, and the like are either done at the offices of a third-party accountant or bookkeeper, or at home. Communications with prospective customers are accomplished by radio contact from the forest floor or at home. A primary responsibility of a capital-intensive small businessman is effective on-site management of the assets in which he has invested - not sitting in an office.

During the July 1979 hearings of this subcommittee, then Subcommittee Chairman Rostenkowski noted the need for certainty with respect to tax responsibilities. Unless a capital-intensive businessman incurs and bears a new and unnecessary overhead burden, APA seriously questions whether or not the place of business alternative brings any greater degree of predictability to status questions. That part of the place of business alternative which permits a portion of a personal residence to qualify as a principal place of business if it is regularly and exclusively used as such, closely parallels a statutory requirement for the deductibility of office at home expenses. This provision has spawned considerable litigation, reflecting the serious differences of opinion between taxpayers and the IRS, and today, the IRS and the courts. If it were to be used for this bill, uncertainty rather than certainty would be enhanced. There remains unanswered the threshold question of why a test, formulated to correct perceived abuses and curtail deductions from income for home expenses, should be determinative of the question of whether or not one is an independent businessman.

Given the risk associated with the exclusive and regular use test, businessmen would be better advised to simply set up a separate and distinct place of business, whether they need it or not. Thus, the impact is potentially artificial and definitely negative and costly. The potential artificiality arises because there is no requirement that a place of business be necessary for the conduct of business. It need only exist and not be provided by the service-recipient. The net result is an alternative that simply requires a costly and unnecessary overhead burden.

There is a further invidious result. A new asset, real estate, may be brought into the business. It is an unproductive asset on which the return is effectively zero. Yet, it must be included among the assets to be considered to satisfy the H.R. 5867 asset alternative, thereby further assuring that the asset alternative is not available to capital-intensive enterprises.

APA suggests that the overall productivity problems of American industry, both large and small, are far better served when the tax structure does not foster or direct investment in fallow assets.

The Structural Deficiency of H.R. 5867

A major structural difference between H.R. 5867 and H.R. 6311 is that H.R. 5867 places risk of income fluctuation as a distinct safe harbor requirement. Having risk of income fluctuation as a distinct requirement is a "double dip" against capital-intensive contractors, and reflects a lack of understanding with respect to the essentials of capital finance, the role of the marektplace in the valuation of services, and a misunderstanding of the risk undertaken in various types of businesses.

Capital investments are generally financed. Normal financial institutions are risk minimizers, not risk maximizers. They finance against two factors. First is the asset itself; second is the stream of future earnings that will be produced by the asset.

Capital-intensive small businessmen must operate within the bounds of established capital sources. An extremely significant risk is undertaken when the commitment is made to purchase, pay for, and operate the asset productively. The opportunity to limit another risk, income fluctuation, must be permitted to enable the capital-intensive businessman access to financial sources. This is not to say that risk of income fluctuation is never present. The current economic situation is absolute proof otherwise. It is to say, however, that the risk occurs over an entire economic cycle, not with every sale of the service or neatly within any given taxable year. The product of the services of APA members, harvested timber, is expensive to produce. There must be a degree of certainty about the market before a reasonable businessman will incur the expense and investment required to offer the service.

The Ultimate H.R. 5867 Quandry For Capital-Intensive Small Businessmen

Because H.R. 5867 requires meeting both the asset and income fluctuations tests, it is a "damned if you do and damned if you don't" proposition. During taxable years occuring in depressed economic times, many capital intensive businessmen may find their profit and loss statement showing no income or an outright loss. Is there not any better proof that the individual risks income fluctuation? Yet, the moment a loss occurs, the capital-intensive businessman cannot meet the asset alternative. His return on assets is either zero or negative.

During favorable economic times, because the demand for the product produced by their services is great, logging contractors have been able to negotiate agreements on a "take or pay" basis at high values. Given a "take or pay" contract, the individual may no longer risk income fluctuation in the sense required by the income fluctuation test. Thus, during favorable times, when he may have a chance* to meet the requirements of the asset alternative, the capital-intensive businessman may not fulfill the income fluctuation test - CATCH 22!

Conclusions With Respect to the Impact of the Safe Harbor Provisions of H.R. 5867 on Small Capital-Intensive Businessmen

The small capital-intensive contractor is essentially denied the H.R. 5867 safe harbor, unless he unnecessarily adds to his already significant overhead and asset burden. The asset alternative is so fundamentally flawed in an economic sense that it is probably incapable of proof by any taxpayer. Given the separate income fluctuation requirement and the proposed statutory wording of the asset alternative, the investment undertaken by capital-intensive contractors is simply not being recognized as a risk for purposes of H.R. 5867.

---

*A 33 1/3% investment return remains unlikely even during the best of economic times.

The H.R. 5867 quandry places capital-intensive contractors in an untenable position. If investment return is to be an appropriate measure of the value of the service attributable to property, the contractor must prove a return on assets of 33 1/3%, and at the same time prove that he risks income fluctuation. Of course, when risk of income fluctuation is proven, it is definitively proven that the return on the assets in the business is a variable, and the yield may or may not be 33 1/3% at any given point in time. Once the contractor has definitively proven that his return is a variable, how is it then possible to prove that one-third of the value of the service is attributable to assets? Conversely, if a capital-intensive businessman can prove a "guaranteed" investment return of 33 1/3% (or any other "guaranteed" yield) thereby fulfilling the requirements of the asset alternative, he has proven, on a virtually conclusive basis, that his risk of income fluctuation must be minimal to nonexistent.

Because of the "double dip" approach (meeting both the asset alternative and the income fluctuation test), H.R. 5867 requires the capital-intensive contractor to bear all market risks under all market conditions (good or bad) at all times. He cannot move to shift, minimize, or negate certain risks whenever market opportunities would otherwise permit him to do so, without incurring the risk of an attack upon his status. Succinctly and perhaps too bluntly put, he must, for tax reasons, operate and manage his business like an idiot. Were he that, he would not be in the business, or have the assets necessary to offer the service in the first place.

Use of investment return as a measure of the value attributable to assets may have the surprising consequence of discouraging investment. The equation for return of assets is income divided by the asset value with the result normally expressed as a percentage. One method of achieving the high return mandated by the asset alternative is to minimize the value of the assets employed in the business whenever possible. A further unintended result may be the encouragement of service-recipient financing. Sophisticated accounting coupled with service-recipient financing could produce astounding returns on the assets to be considered for purposes of the asset alternative.*

The H.R. 5867 safe harbor has one result. Capital-intensive small businessmen must invest in a fallow asset and incur the needless expense of a separate and distinct principal place of business if they are to operate their businesses without fear of a challenge to their status as viable independent businessmen.

H.R. 5867 and Mandatory Withholding

The most tragic flaw of H.R. 5867 is the institution of flat rate mandatory withholding on payments to independent contractors. We noted in the background section at the beginning of our comments on H.R. 5867 that logging is a series of financial variables. Although redundant, we wish to restate our actual operating conditions.

1. The price for our members' services is a variable and is derived from demand in end-use markets.

2. All inputs - fuel, lubricants, wages paid, interest on capital financing, repairs, equipment - and all external factors affecting operation efficiency - terrain, tree size, weather - all are costs, all affect costs, and all are variables.

3. All the variables are highly volatile - witness the recent gyrations in fuel prices or interest rates alone.

Therefore, every logger's income is a variable and an unpredictable variable. Withholding against a variable is absurd. In reality, it is a contradiction in terms. Under current market conditions for loggers, a withholding tax would represent a confiscatory tax. The result of a confiscatory tax should be obvious. It is the premise already stated - withholding would be a lethal blow to the independent logging businessman and to many other capital-intensive small businessmen. We can virtually assure you that the final chapters of the withholding saga will be Chapter VII, X, or XI of the United States Bankruptcy Code.

---

*Sophisticated accounting may be unnecessary. The H.R. 5867 asset alternative states only that "assisted" assets shall not be considered. There is no corresponding statutory authority to decrease the value of the service "attributable" to assisted assets.

WHAT IS REALLY AT STAKE

There is a natural human tendency to want the best of all worlds. Who would not prefer complete freedom to make all business decisions, to be accountable to no one, and also to have all the security characteristic of an employment relationship?

However, a difficult choice prevails. To be an independent businessman, one foregoes the security of employment, becomes accountable to the marketplace, and becomes directly responsible for taxes and insurance required. To be an employee, one foregoes the right to determine the manner and means of performance and becomes accountable to an employer, who serves as an agent of government in tax withholding and other legally mandated employer responsibilities.

What is at stake here for all industry and particularly for the logging industry is that this choice of being a businessman or an employee could be determined by a return to IRS practices prevalent before 1979, rather than by business reality and economic factors. The net result over time is a probable massive reallocation and misallocation of scarce economic resources.

Previous IRS practices seem to have been based on the mistaken notion that tax considerations are a "high stakes" factor in making the decision to use the services of, buy from, or sell through independent contractors. This narrow view does not comport with the real world of economic relationships that exists in the logging business. The reality of logging is simply that the tax laws do not and cannot determine whether or not employees or independent contractors are used. Rather, regional land ownership patterns, market availability, the nature of regional timber stands, capital considerations, equipment considerations, landowner preferences, financing considerations, economic merchandizing of harvested timber, distance to market, and a host of other economic and entrepreneurial forces are at play. In logging, independent contractors exist and are successful only in those business relationships where their products and services maximize the economic return from all resources.

The worst possible consequence for APA members is a return to pre-1979 conditions, when IRS actions had the effect of forcing legitimate independent businessmen into an unwanted and economically wasteful employment status. Ease of tax administration was being placed above the benefits that accrue from independent entrepreneurial activity.

CONCLUSION

H.R. 6311 is the solution to the real problem before us today: status. It brings predictability and clarity to an area that has been made unnecessarily confusing. It will enhance tax compliance without supplanting the common law test and without disturbing economic relationships of proven efficiency and workability.

We fully support better reporting, and we will continue our own efforts to make sure that those in our industry know their proper tax obligations. Congressional resolution of this issue, clearly identifying who is or is not an independent contractor upon realistic criteria, will assure the success of our endeavors to enhance compliance with the nation's tax laws.

Chairman STARK. Mr. Scanlon.

STATEMENT OF MICHAEL T. SCANLON, VICE PRESIDENT FOR MOTOR FUELS POLICY, NATIONAL OIL JOBBERS COUNCIL

Mr. SCANLON. I am Mike Scanlon, vice president of the National Oil Jobbers Council. I am accompanied today by Janet Newport, our legislative director.

The NOJC members market approximately half of the gasoline sold in the United States and about 85 percent of the home heating oil. Marketers of these two products engage independent contractors for two primary purposes. The first is to sell fuels through either retail service station outlets or to bulk consumer accounts. In this case a contractual arrangement is agreed to in which the commissioned agent or the independent contractor is paid according to the number of gallons of products sold.

The second is to provide home furnace maintenance service to customers of heating oil dealers. Independent contractors provide heating equipment repair, preventive maintenance, and/or after-hours emergency service to heating oil dealer's customers.

As an alternative to relying on the common law rules, several proposals set forth specific tests to help define who is or who is not an independent contractor. NOJC's comments on each of these tests are outlined as follows:

As regards control of the number of hours worked, marketers who own a retail station and enter into a business relationship with an independent contractor should have a reasonable expectation that the petroleum marketing facilities will be open to the public during reasonable hours.

Since a marketer's income is in many instances dependent upon the volume of products sold, the marketer should be able to expect a reasonable number of working hours at outlets operated by or leased by independent contractors.

In the case of the furnace maintenance contractor, marketers should be allowed to specify that the independent service contractors provide certain hours of service for both normal business calls and for emergency heating equipment repair. Marketers need to know, particularly if an emergency service is required, that the customers have access to qualified professional maintenance.

We respectfully suggest that the subcommittee consider allowing for more flexibility in the control of the hours test for industries such as the petroleum marketing industry that are expected by the public and by market competition to maintain customary hours and services.

Regarding maintenance of a separate place of business, not by the principal, unless a fair rent is paid, many marketers own service station properties which they lease to independent contractors. Some contractors pay a flat monthly rental to the owner. However, many independent contractors pay a rental which is factored into the price of each gallon of product. Since an independent contractor's income is derived not from the property itself but from the sale of product, or other services such as car repair, investment in property seems to be an unnecessary indication of a contractor's independence.

Regarding worker risks income fluctuations, or has substantial economic investment in assets used to perform the service, we are concerned with the investment in tools or assets aspect of this provision.

The contractor can be independent in that he or she operates and controls a business separate from the marketer. The tools or real estate used is irrelevant as long as the business decisions are made by the contractor, and the subcommittee should consider giving more attention to the contractor's ability to hire and fire his own employees, set the retail prices for merchandise, and to whether the primary gain from the work effort accrues to the contractor rather than to the suppliers, lessors or franchisers.

Regarding written contracts identifying the worker as an independent contractor, we think that this is reasonable, and would make clear that the independent contractors understand that they are responsible for the payment of their own taxes to the Federal Government.

Prior to the moratorium on IRS reclassification of independent contractors, the Service engaged in practices that were unfair to petroleum product marketers.

In the case of some of our marketers and their relationships with independent contractors, the IRS would redefine the independent contractor as an employee and assess 3 years back taxes on the marketer without any effort to determine if the contractor had paid the proper amount of tax.

It is critical that limitations be set limiting IRS's ability to target the sevice recipient for noncompliance by a contractor. Predatory enforcement is inherently unfair, and burdensome to innocent small business owners who have made good-faith efforts to properly structure their contractual relationships.

Finally, we would like to state our total opposition to any provisions which would require mandatory withholding for all independent contractors strictly for tax compliance purposes. Such a proposal would place the enforcement burden not on the independent contractor but on the small business petroleum marketers that we represent.

We thank you for your consideration and would be happy to answer questions later, if you have any.

Chairman STARK. Thank you, Mr. Scanlon.

[The prepared statement follows:]

STATEMENT OF MICHAEL T. SCANLON, VICE PRESIDENT FOR MOTOR FUELS POLICY, THE NATIONAL OIL JOBBERS COUNCIL

PREFACE

The National Oil Jobbers Council is a federation of 42 state and regional trade associations representing thousands of independent small business petroleum marketers. Members include gasoline and diesel fuel wholesalers, commissioned distributors of gasoline, gasoline reseller-retailers and a large number of retail fuel oil dealers. Members also wholesale or retail many other petroleum products, including kerosene, LP gas, aviation fuels and motor oils as well as residual fuel oil. Together our members market approximately 50 percent of the gasoline and 85 percent of the home heating oils sold in America under either their own private brand or the trademark of their supplier.

Good morning Mr. Chairman and members of the subcommittee. My name is Michael Scanlon and I am Vice President for Motor Fuels Policy for the National Oil

Jobbers Council (NOJC). I am pleased to be here today on behalf of NOJC, a federation of 42 state and regional trade associations representing 15,000 small independent business marketers of petroleum products (see attachment). These individuals sell approximately 50 percent of the gasoline and 85 percent of the home heating fuels consumed in the United States. Because many of these marketers use independent contractors to sell motor fuels or to perform home furnace maintenance, the National Oil Jobbers Council has a particular interest in independent contractor classification legislation. We commend the Chairman and members of the subcommittee for thier efforts to find a solution to the classification problems and thank the subcommittee for its consideration of our views.

BACKGROUND

Marketers of gasoline and heating oil products engage independent contractors for two primary purposes. The first is to sell fuels through either retail service station outlets or to bulk consumer accounts. In this case a contractual arrangement is agreed to in which the commissioned agent or independent contractor is paid according to the number of gallons of product sold. The second is to provide home furnace maintenance service to customers of heating oil dealers. Independent contractors provide heating equipment repair, preventive maintenance, and/or after hours emergency service to a heating oil dealer's customers.

THE SAFE HARBOR TESTS

As an alternative to relying on the common law rules, several proposals set forth specific tests to help define who is or is not an independent contractor. The NOJC's comments on each of these tests are outlined as follows:

Control of the number of hours worked.—The marketers who own a retail station and who enter into a business relationship with an independent contractor (dealer) should have a reasonable expectation that petroleum marketing facilities will be open to the public during reasonable hours. Since a marketer's income is in many instances dependent on the volume of product sold, the marketer should be able to expect reasonable working hours at outlets operated by and/or leased to an independent contractor (dealer).

In the case of furnace maintenance contractor, marketers should be allowed to specify that independent service contractors provide certain hours of service for both normal business calls and for emergency heating equipment repair. The marketers need to know, particularly if emergency service is required, that their customers have access to qualified professional maintenance. This is critical during winter months when prompt maintenance and emergency service work is necessary and is particularly critical for the elderly and for families with small children. If an independent contractor is unwilling to do emergency work, then he or she can choose to work for someone else, but if they agree to provide that type of service, the heating oil marketer should be allowed to specify certain hours when the contractor should be available to provide the necessary customer service.

NOJC respectfully suggests that the subcommittee consider allowing for more flexibility in the control of hours test for industries, such as petroleum product marketing, that are expected by the public and market competition to maintain customary hours and service.

Maintenance of a separate place of business, not by the principal unless a fair rental is paid.—Many marketers own service station properties which they lease to independent contractors. Some contractors pay a flat monthly rental to the owner. However, many independent contractors (dealers) pay a rental which is factored into the price of each gallon of product. Since an independent contractor's income is derived not from the property, but from the sale of product or other services, such as car repair, investment in property seems to be an unnecessary indication of a contractor's independence.

The worker risks income fluctuations or has substantial economic investment in assets used to perform the service.—NOJC is concerned with the investment in tools or assets aspect of this provision. The contractor can be independent in that he or she operates and controls a business separate from the marketer-the tools or real estate used in irrelevant as long as the business decisions are made by the contractor. The subcommittee should consider giving more attention to the contractor's ability to hire and fire employees, set the retail sales prices for merchandise, and to whether the primary gain from work efforts accrues to the contractor rather than the suppliers, lessors, or franchisors.

Written contracts identifying the worker as an independent contractor.—This is reasonable and would make clear that the independent contractors understand that they are responsible for payment of their taxes to the federal government.

IRS ENFORCEMENT

Prior to the moratorium on IRS reclassification of independent contractors, the Service engaged in practices that were unfair to petroleum product marketers. In the case of some petroleum marketers and their relationships with independent contractors, the IRS would redefine the independent contractor as an employee and assess three-year's back taxes on the marketer without any effort to determine if the contractor had paid the proper amount of tax.

While NOJC appreciates and understands the subcommittee's interest in encouraging tax compliance, too often the IRS has penalized not the real offenders, but the businessmen and women who had entered into business relationships with the understanding that the contractor was responsible for paying proper taxes. It is critical that limitations be set limiting IRS' ability to target the service recipient for non-compliance by a contractor. Predatory enforcement is inherently unfair and burdensome to innocent small business owners who have made good faith efforts to properly structure their contractor relationships.

MANDATORY WITHHOLDING

Finally, NOJC would like to state its total opposition to any provisions which require mandatory withholding for all independent contractors strictly for tax compliance purposes. Such a proposal would place the enforcement burden not on the independent contractor, but on the small business petroleum marketers NOJC represent.

NOJC appreciates your consideration of our views and I will be happy to answer your questions.

Members of the National Oil Jobbers Council.—NOJC represents these member associations:

Alabama Petroleum Marketers Association, Arizona Oil Marketers Association, Arkansas Oil Marketers Association, Inc., California Independent Oil Marketers Association, Colorado Petroleum Marketers Association, Independent Connecticut Petroleum Association, Delaware Petroleum Marketers Association, Florida Petroleum Marketers Association, Georgia Oilmen's Association, Idaho Oil Marketers Association, Indiana Oil Marketers Association, Inc., Intermountain Oil Marketers Association, Iowa Independent Oil Jobbers Association.

Kansas Oil Marketers Association, Kentucky Petroleum Marketers Association, Louisiana Oil Marketers Association, Maine Oil Dealers Association, Michigan Petroleum Association, Mid Atlantic Petroleum Distributors Association, Inc., Mississippi Petroleum Marketers Association, Missouri Oil Jobbers Association, Montana Chapter, Intermountain Oil Marketers Association, Nebraska Petroleum Marketers, Inc.

Independent Oil Men's Association of New England, Better Home Heat Council of New Hampshire, Fuel Merchants Association of New Jersey, New Mexico Petroleum Marketers, Empire State Petroleum Association, North Carolina Oil Jobbers Association, Ohio Petroleum Marketers Association, Oklahoma Oil Marketers Association, Oregon Oil Jobbers Association, Pennsylvania Petroleum Association.

South Carolina Oil Jobbers Association, South Dakota Independent Oilmen's Association, Tennessee Oil Marketers Association, Texas Oil Marketers Association, Virginia Petroleum Jobbers Association, Washington Oil Marketers Association, West Virginia Oil Jobbers-Distributors Association, Oil Jobbers of Wisconsin, Inc., Wyoming Petroleum Marketers Association. National Oil Jobbers Council, 1707 H Street, N.W., Washington, D.C. 20006, (202) 331-1198.)

Chairman **Stark.** Mr. McNeer.

STATEMENT OF JOHN D. McNEER, FORMER MEMBER OF THE BOARD, SPECIALTY ADVERTISING ASSOCIATION INTERNATIONAL (VICE PRESIDENT, NEWTON MANUFACTURING CO.), ACCOMPANIED BY H. TED OLSON, PRESIDENT, AND MALCOLM D. MacARTHUR, GENERAL COUNSEL

Mr. **McNeer.** Mr. Chairman and members of the subcommittee, my name is John D. McNeer. I am senior vice president of Newton

Manufacturing Co., Newton, Iowa, and I am appearing here today on behalf of the Specialty Advertising Association International. With me is H. Ted Olson, to my left, president of that association, and Malcolm D. MacArthur of the Washington, D.C., law firm of Keller & Heckman, who serves as general counsel for the association. We appreciate this opportunity to testify on behalf of our association on proposals for legislation relating to independent contractors.

The specialty advertising industry is composed of approximately 6,000 firms which either manufacture or sell specialty advertising products. Such products consist of useful items such as this ballpoint pen, which are imprinted with advertising messages and distributed free of charge for advertising purposes. Our products are sold to advertisers by approximately 30,000 salespersons who are independent contractors under the common law rules.

Our industry has faced the same problems resulting from IRS reclassification of its salespeople as employees which others have testified about today and at previous hearings. We therefore support the enactment of the safe-harbor tests for determining independent contractor status that are contained in H.R. 4531, H.R. 6311, and other bills before the subcommittee.

We strongly oppose the proposal for a flat 10 percent withholding on independent contractors because it would be very burdensome to our industry from an administrative standpoint. We also believe the proposal is unnecessary, particularly if bills mandating improved reporting were enacted.

Our main purpose in testifying, however, is to address provisions in several bills dealing with "traveling or city salesmen" and other so-called statutory employees that are defined in section 3121(d) of the Internal Revenue Code.

Some of the independent contractor salespersons in our industry fall within the definition of "traveling or city salesmen" under section 3121(d) of the code. This means that they are presently treated as statutory employees for purposes of social security taxes and unemployment compensation taxes, but they are not subject to income tax withholding.

Under section 5 of H.R. 4531, however, "traveling or city salesmen" would be treated as employees for purposes of income tax withholding. In addition, under section 3508(c)(2) of H.R. 4531, and several other bills, including H.R. 6311, the safe-harbor tests would not apply to "traveling or city salesmen" for any purpose, including income tax withholding.

Mr. Chairman, we oppose those provisions. We believe that traveling or city salesmen should not be treated as employees for purposes of income tax withholding. They should continue to be, as they are now, independent contractors for those purposes. We further believe that the safe-harbor tests should be applicable to traveling or city salesmen for purposes of income tax withholding.

As we explained in detail in our written statement, requiring that "traveling or city salesmen" be treated as employees for purposes of income tax withholding would be extremely burdensome to our industry—and I am sure to others.

In addition, it would subject many of our companies to new and unclear tax liabilities of the kind that the independent contractor bills were intended to eliminate.

I also wish to point out that we know of no sound reason why the safe-harbor tests should not be applied to traveling or city salesmen for purposes of income tax withholding. The main purposes of such tests are to provide greater clarity and certainty in classifying workers for tax purposes. These purposes apply with equal force to the classification of traveling or city salesmen.

In conclusion, we urge that section 5 of H.R. 4531, or any similar provision, which would make traveling or city salesmen employees for purposes of income tax withholding, not be included in any final bill that is approved. We also ask that any such bill contain language similar to section 3508(e)(1) of H.R. 4971. That section makes it clear that the safe-harbor tests would apply to traveling or city salesmen for purposes of income tax withholding.

Finally, Mr. Chairman, if a safe-harbor bill is not enacted by June 30, 1982, we urge that the interim relief provided by section 530 of the Revenue Act be extended.

[The prepared statement follows:]

STATEMENT OF JOHN D. McNEER ON BEHALF OF THE SPECIALTY ADVERTISING ASSOCIATION INTERNATIONAL

Mr. Chairman and Members of the Subcommittee: My name is John D. McNeer. I am Senior Vice President of the Newton Manufacturing Company of Newton, Iowa. I am a former member of the Board of Directors of the Specialty Adverticing Association International (SAAI), and I am appearing today on behalf of that Association. Accompanying me are H. Ted Olson, President of SAAI, and Malcolm D. MacArthur of the Washington, D. C. law firm of Keller and Heckman, who serves as general counsel to the Association. We appreciate this opportunity on behalf of SAAI to discuss H.R. 4531, H.R. 6311, and other proposals regarding the tax treatment of independent contractors.

SUMMARY OF VIEWS

SAAI supports enactment of the safe-harbor tests for determining independent contractor status that are set forth in proposals before the Subcommittee. However, we strongly oppose any provisions for withholding from independent contractors, including the proposal for a flat 10 percent withholding contained in H.R. 5867. We do so because such provisions would be unduly burdensome from an administrative standpoint and would be unnecessary if proposals for improved reporting were enacted.

We also oppose the provision in H.R. 4531 that would require "traveling or city salesmen" to be treated as employees for purposes of income tax withholding. The latter provision would impose a virtually impossible burden of compliance on firms in our industry and other industries which rely on "traveling salesmen" to sell their products. Moreover, it would drastically and unfairly increase the potential tax liability of firms required to interpret the extremely vague and complex definition of "traveling or city salesmen" contained in section 3121(d)(3)(D) of the Code. In addition, the provision would have a severely disruptive effect on our industry, since it would cause many firms to treat their independent contractor salespersons as employees for all purposes, contrary to the desires of those salespersons.

Finally, we oppose the language in section 3508(c)(2) of H.R. 4531 and H.R. 6311 which would render the safe-harbor tests inapplicable to "traveling or city salesmen" for income tax withholding purposes. We believe that the safe-harbor tests should be made applicable to "traveling salesmen" for income tax withholding purposes. The same need for clarity and certainty exists in classifying such persons as employees or independent contractors as exists with respect to other workers. Firms that rely on "traveling salesmen" have a particular need for relief from the complexities of the employment tax laws, because they face the doubly difficult burden of applying both the common law test and the equally confusing "traveling salesmen" test. We believe many such firms would reclassify their salesmen as employees rather than face the severe uncertainties of the common law tests. Yet, such reclassifications would have a harmful effect, since they would be contrary to the desires of most specialty advertising salespersons who want to be their own bosses.

THE SPECIALTY ADVERTISING INDUSTRY

The Specialty Advertising Association International is the trade association that represents the specialty advertising industry. Its 2,600 member firms, located in virtually all states, manufacture or distribute specialty advertising products. Specialty advertising is an advertising medium which uses useful but inexpensive items to carry an advertising message. Examples of such products are ballpoint pens, key chains, and calendars which are custom imprinted with the name, logo or other identification of the advertiser and distributed free of charge for advertising or promotional purposes. In 1981 sales of specialty advertising products by all forms in the industry were in excess of $3 billion. There are approximately 5,500 firms in the industry, the overwhelming majority of which are small businesses.

Manufacturers of specialty advertising products sell their merchandise through firms known as distributors. Distributors receive orders from salespersons who make the actual contacts with the advertisers and sell the products to such advertisers. The salespersons typically derive their income solely from commissions and operate away from the premises and free from the control of their principals. There are approximately 30,000 of such salespersons, and the great majority of them are independent contractors under the usual common law rules.

INDEPENDENT CONTRACTORS IN THE SPECIALTY ADVERTISING INDUSTRY

The dynamic growth of the specialty advertising industry in the past ten years has been achieved in large part as a result of the independent contractor salespersons who sell the industry's products. Such persons place a high value on being independent in carrying out their work. They prefer to be their own bosses, to control their own hours, to solicit the accounts of their own choosing, to keep their own records and books, and to conduct their business away from any office or fixed location. They do not regard themselves as employees and do not wish to be so treated.

Most specialty advertising salespersons work full or part time on behalf of one principal. They solicit orders from virtually all types of business firms and other entities that desire to use the specialty advertising medium. Potential buyers include not only business firms, such as manufacturers, wholesalers, retailers and financial institutions, but also nonprofit organizations, political parties and candidates, government institutions and many other entities. While some salespersons specialize in soliciting certain accounts, most sell to a wide variety of businesses and other entities.

For a number of years, specialty advertising distributors, for whom the independent contractors perform selling services, have been faced with two exceedingly difficult tax problems regarding their salespersons. One is whether the salespersons will be classified by the IRS under common law rules as employees for employment tax purposes. The other is whether the salespersons—even though clearly independent contractors under the common law tests—will nevertheless be regarded as "traveling or city salesmen" (and therefore statutory employees) for purposes of social security (FICA) taxes and unemployment compensation taxes (FUTA) under section 3121(d)(3)(D) of the Internal Revenue Code and regulations.

The Subcommittee is well aware of the first of these two problems. The lack of uniformity and unfairness in IRS' interpretations of the common law tests led to the passage of section 530 of the Revenue Act of 1978 (P.L. 95-600), and subsequent extensions of that law, which provided interim relief from IRS reclassifications of workers as employees for tax purposes. Since that time, considerable testimony has been presented on the need for certainty in classifying workers as employees or independent contractors for tax purposes.

Our Association is in complete agreement on the need for certainty in this respect and supports the enactment of legislation which would provide clear and objective tests for determining independent contractor status.

We point out, however, that our industry also has been faced with another equally serious problem in determining the status of its salespersons. The problem results from the exceedingly complex and confusing definition of "traveling or city salesmen" contained in section 3121(d) of the Code. Under that section, traveling or city salesmen who qualify as independent contractors are treated by statute as employees for purposes of social security (FICA) taxes and unemployment compensation (FUTA) taxes, but are not subject to income tax withholding. We do not have statistics showing how many of the 30,000 salespersons in the specialty advertising industry are "traveling or city salesmen". We believe, however, that a significant percentage may come within that category.

Section 3121(d) of the Code defines "traveling or city salesmen" as follows:

"(d) Employee.—For purposes of this chapter, the term 'employee' means—(3) any individual (other than an individual who is an employee under paragraph (1) or (2) who performs services for remuneration for any person—

"(D) as a traveling or city salesman, other than as an agent-driver or commission-driver, engaged upon a full-time basis in the solicitation on behalf of, and the transmission to, his principal (except for side-line sales activities on behalf of some other person) or orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments for merchandise for resale or supplies for use in their business operations; if the contract of service contemplates that substantially all of such services are to be performed personally by such individual; except that an individual shall not be included in the term 'employee' under the provisions of this paragraph if such individual has a substantial investment in facilities used in connection with the performance of such services (other than in facilities for transportation), or if the services are in the nature of a single transaction not part of a continuing relationship with the person for whom the services are performed."

A revenue fuling provides in part that "[g]enerally, a traveling or city salesman will be presumed to meet the 'principal business activity' test in any calendar quarter in which he devotes 80 percent or more of his working time and attention to the solicitation of orders for one principal from wholesalers and/or the other customers specified for merchandise for resale or supplies of the requisite character." [Rev. Rul. 55-31, § 3(a).]

To further complicate the problem of interpretation, an IRS regulation says that "multiple-line salesmen" who solicit orders on behalf of other principals are not included within the definition unless their solicitation of orders for other principals consists only of "side-line sales activities". [IRS Reg. § 31.3121(d)-1(iv)(b).]

Section 3121(d)(3)(D) and the rulings and regulations interpreting it create truly horrendous compliance problems for specialty advertising distributors. Under this section, during each calendar quarter the distributors must make the complex and burdensome determination whether any of its salespeople devoted 80 percent or more of his time selling to "wholesalers, retailers, contractors, or operators of hotels, restaurants or other similar establishments".

Frequently, however, it is unclear whether the business firm comes within the specified categories. Some of the major users of specialty advertising do not clearly fall within these categories, e.g., banks, savings and loan associations, credit unions, insurance companies, and trucking lines. Moreover, the only way a salesperson could know if he spent 80 percent of his time selling to the specified categories of firms would be for him to keep careful records of each hour he spent in his work. However, to require independent contractor salesmen to keep such records is highly impractical.

Finally, in many cases it is difficult to determine whether a salesperson in a given calendar quarter was a "multipleline salesman" or a salesman who worked primarily for one principal and engaged in only "side-line sales activities". For one thing, the meaning of the term "sideline sales" is far from clear. Moreover, to obtain such information from an independent contractor salesman about his activities would require exercising direction and control to a degree that could well cause the saleperson to be regarded as an employee under common law rules.

In sum, specialty advertising firms that use salespersons that could be classified as "traveling or city salesmen" presently must make two difficult determinations: (1) whether the salespersons will meet the common law tests for independent contractor status; and (2) whether in any calendar quarter they come within the definition of "traveling or city salesmen".

INDEPENDENT CONTRACTOR PROPOSALS GENERALLY

We support the safe-harbor provisions of the various bills that are pending before the Subcommittee, and we urge that a bill containing such provisions be enacted before June 30, 1982, when the interim relief provided by Section 530 of the Revenue Act is due to end. We strongly urge that the interim relief be extended for at least another year if for any reason a safe-harbor bill is not enacted by June 30.

Turning to the bills before the Subcommittee, we unequivocably support H.R. 4971 and H.R. 5729. As explained below, we strongly oppose several provisions in H.R. 4531 and H.R. 6311; however, if those objectionable provisions were eliminated, we would also be in favor of those bills. We oppose the 10 percent withholding provision in H.R. 5867.

The provisions in H.R. 4531 and H.R. 6311 to which we object are: (1) Section 5 of H.R. 4531 which would cause "traveling or city salesmen" to be treated as employees for purposes of income tax withholding; and (2) section 3508(c)(2) of H.R. 4531 and H.R. 6311 which would prevent the safe-harbor tests from being applied to "traveling or city salesmen" for purposes of income tax withholding.

SECTION 5 H.R. 4531

We urge that language similar to Section 5 of H.R. 4531 be eliminated from any bill approved by the Subcommittee. In the first place, requiring traveling salesmen be treated as employees for income tax withholding purposes would impose an intolerable burden on the specialty advertising industry. It would mean that each time a distributor sent a commission check to a salesperson, the distributor would have to make a new and separate determination whether to treat the salesperson as a "traveling salesman" and withhold income tax from that check. From an administrative standpoint, this would simply be unworkable.

The application of section 3121(d)(3)(D) of the Code depends on a number of factors that change monthly, weekly and even daily. The factors are the nature of each of the salesmen's accounts (i.e., whether they are retailers, wholesalers, etc.), the amount of time the salesman spends on soliciting each account, and the extent to which he sells for other principals. Thus, the salesperson might be classifiable as a "city or traveling salesman" one day but not another, or during one week or month but not another. We submit that no business, large or small, could possibly make such difficult and endless tax determinations and remain in business.

Second, the requirement would have a severely disruptive effect on our industry's relations with its salesmen on whom we so heavily depend. Those salespersons are staunchly independent. They do not want to be treated as employees; many would rather leave the industry if they could no longer be their own bosses. Yet, if they have to be treated as employees for withholding purposes, many of the firms for which they render services would probably decide to treat them as employees for all purposes. By doing so, such firms will eliminate the burdensome compliance problem under the statute and would be able to enjoy the efficiencies which result in being able to exercise direction and control over a sales force.

We should also point out that requiring a firm to obtain such detailed information about a salesperson's accounts, the time he spends soliciting them, and the amount of work he does for other principals, places the firm in a "catch 22" situation. Under the usual common law rules, a principal may exercise no direction or control over an independent contractor. To do so would cause the worker to be classified as an employee for all purposes. Yet, a firm cannot obtain the needed information unless he directs the salesperson to furnish it and generally exercises more supervision and involvement with the salesperson than is permitted under common law rules.

Third, the requirement in H.R. 4531 would subject all of the 4,000 distributors in our industry to assume the risk of an even greater potential tax liability based on the interpretation of a vague and complex statute. It is bad enough to subject them to potential liability for back FICA and FUTA taxes when IRS disagrees with their interpretation of this statute. It would be far worse to impose on them the even greater potential liability for income tax withholding.

SECTION 3508 (C) (2) OF H.R. 4531 AND H.R. 6311

We strongly disagree with the wording of section 3508 (c)(2) of H.R. 4531 and H.R. 6311, which provides that the safe-harbor definitions would not apply to "traveling and city salesmen" (and other individuals described in section 3121(d) of the Code).

We understand why the definitions should not apply for purposes of social security taxes, since under current law the individuals described are treated as statutory employees for purposes of social security and unemployment compensation taxes. But there is no logical reason why the bill's safe-harbor provisions should not be applied to such individuals for purposes of income tax withholding. Indeed, all of the reasons for having safe-harbor definitions in the first place apply with equal force to "traveling or city salesmen". Firms in our industry that have such salespersons share the same need for clarity and certainty regarding the proper tax classification of their workers as any other firms that use independent contractors. Moreover, it would be particularly unfair to deny such firms the benefit of the safe-harbor definitions, since they face the doubly difficult burden of having to apply both the common law test and the "traveling salesman" test. They should be among the most deserving of the relief from uncertainty provided by the safe-harbor tests.

Finally, preventing the tests from applying to "traveling salesmen" would undoubtedly force many of our industry's firms to treat their salespersons as employees for all puposes. Many would seek to do this rather than again face the severe uncertainities of the common law tests and IRS's apparent willingness to exploit those uncertainties. The reclassification by such firms might be fine from the standpoint of the IRS, but it would hurt our industry. The salespersons, on whom we rely so heavily, are staunchly independent. They do not want to be treated as employees. Many would rather leave the industry if they could no longer be their own bosses.

Under the language of H.R. 4791 and H.R. 5729, the safe-harbor tests would apply to "traveling salesmen" [and others in section 3121(d)] for purposes of income tax withholding. We strongly urge that such language be inserted in any final bill on this subject. The language, which appears in section 3508(e)(1) of H.R. 4971, is as follows:

"(e) Special Rules.—(1) Section Not To Apply To Certain Individuals For Purposes of Social Security Taxes.—For purposes of chapters 2 and 21, this section shall not apply to an individual described in section 3121(d)(3) relating to certain agent-drivers, commission salesmen, full-time life insurance salesmen, home workers, and traveling or city salesmen."

The Specialty Advertising Association International does not object to provisions in H.R. 6311 which would impose greater penalties for failure to report payments to independent contractors. We accept such provisions as a reasonable alternative to income tax withholding and believe that they should substantially alleviate any problems of unreported and under-reported income.

PROVISIONS FOR A FLAT 10 PERCENT WITHHOLDING (H.R. 5867)

The proposal for a flat 10 percent withholding in H.R. 5867 would be very harmful to the specialty advertising industry. It would subject our industry to an enormous bookkeeping burden that would hurt many firms. Moreover, we believe that the proposal is unnecessary, particulary if H.R. 6311 were enacted.

CONCLUSION

Taxpayers in the specialty advertising industry and other taxpayers concerned with classifications of workers as employees or independent contractors have long faced difficult problems with the IRS. We therefore commend the Subcommittee for addressing this subject and seeking ways to provide much needed clarity and simplification in coping with these problems. In considering this subject, however, we urge the Subcommittee not to increase our industry's tax compliance problems by subjecting any of its independent contractor salespersons, including "traveling salesmen" to income tax withholding. To do so would unduly burden our industry and perhaps many others. We further urge that the safe-harbor tests be made applicable to "traveling or city salesmen" for purposes of income tax withholding. Finally, we ask that provisions for a safe-harbor test be enacted before June 30, 1982.

Chairman **STARK**. Thank you.

Mr. Duncan.

Mr. **DUNCAN**. I want to thank the panel. I think it has been a good panel. I do not have any particular questions. Thank you.

Chairman **STARK**. Mr. Guarini.

Mr. **GUARINI**. Mr. McNeer, your group is excluded under the common law definition at the present time, is it not?

Mr. **MCNEER**. You say is excluded?

Mr. **GUARINI**. Is it?

Mr. **MCNEER**. For income tax?

Mr. **GUARINI**. Presently the common law definition satisfies your group, as things are today?

Mr. **MCNEER**. Only the traveling or city salesmen into this.

Mr. **GUARINI**. What this would do would be to bring additional people into being independent contractors?

Mr. McNEER. Yes, this would force them to the independent contractorship, of which they are not. They are staunchly independent people.

Mr. GUARINI. So how many additional people, what percentage of your company would be broadened out into the new definition of safe harbor?

Mr. McNEER. That would be a very difficult thing to determine for our company and of our industry, due to the independent contractor nature of those people that are associated with us. We have no control over these people, you know, to ask them to define this.

Mr. GUARINI. A new definition would help exclude from regular income tax reporting, withholding of reporting a certain part of your industry as it is today, I assume from what you have said.

Mr. Scanlon, from the heating oil people, do they fit presently under the common law definition, or would this broaden the horizon for your heating industry?

Mr. SCANLON. It would probably broaden the horizon a little bit for the heating oil side of our business, yes.

Mr. GUARINI. There would be fewer W2's to report from your industry?

Mr. SCANLON. It would not be a significant number in any event, but it would not broaden it by too much.

Mr. GUARINI. Mr. Rolston, I assumed from what you said that they have a hard time from the IRS today, that this would extend the horizon of independent contracting people in the logging industry.

Mr. ROLSTON. No, Mr. Guarini. In fact, we figure at least 15 percent of the contract relationships in logging are still going to have to rely on the common law. There is a lot of variety out there in the woods, and this safe harbor (H.R. 6311) I think covers those situations that are clearcut and traditionally have been held to be independent.

Mr. Chairman, I neglected to introduce my attorney who is sitting next to me, and for the record he is Colin McKevney. We have had him out in the woods. Incidentally, he is one of the few attorneys who knows logging and the law.

Mr. GUARINI. We know a little about logging too. Thank you very much. I appreciate it.

Ms. Rice, I assume that there would also be an extension of the law to cover additional people within your industry also?

Ms. RICE. Yes, but I don't know that—again, like this gentleman said—that that would be a significant increase.

Mr. GUARINI. We will have fewer and fewer W2 forms, Mr. Chairman, to file. Maybe some day we will get to a value-added tax so that we can tax consumption and not worry about income tax-independent contractor hearings.

Thank you.

Chairman STARK. I want to thank the panel. In the best traditions of this subcommittee, we appreciate your being here, and I would like to call the next panel.

We also save the best for the last. We will ask Mr. Golden of the American Movers Conference, and Mr. Perry of the Independent Drivers Association, and Mr. McRae of the American Trucking Association, to constitute our next panel.

I will call you in the order that you appear on the witness list. Mr. Golden, you may proceed to summarize your written testimony in any manner you see fit.

Mr. **Golden**. Mr. Chairman, my remarks are actually supplemental to those of Mr. McRae. With your permission, he will lead and I will follow on that.

Chairman **Stark**. All right, sir.

STATEMENT OF DUNCAN McRAE, JR., VICE PRESIDENT, MELTON TRUCK LINES, INC., ON BEHALF OF THE AMERICAN TRUCKING ASSOCIATIONS, INC.

Mr. **McRae**. I am Duncan McRae, Jr., executive vice president of Melton Truck Lines in Shreveport, Louisiana. I am accompanied by our special counsel, Edward Delaney. We appear on behalf of the American Trucking Associations.

We urge that the historic status of independent truck operators as independent businessmen exercising their entrepreneurial spirits and talents be continued.

The effectiveness of the motor transport system is in no small measure the result of the dedication of these independent operators. This dedication comes from the fact that the independent truck operator is an independent businessman in control of his own work habits, and to that extent in control of his own destiny.

The substantial monthly cash demands imposed upon an independent operator reflect his cost of investment, maintenance of equipment, operating expenses, and are estimated to be at least 70 percent of his gross revenue.

We are fully aware of the attack by the Internal Revenue Service during the 1970's upon the small businessman's status as an independent contractor. Therefore, we support a legislative effort to enact statutory safe harbor rules based upon the common law.

The independent contractor status of independent truck operators for employment tax purposes was first challenged by the Service in a series of cases in the 1940's. That controversy culminated in a Supreme Court decision, *Harrison* v. *Greyvan Lines, Inc.*, which recognized the independent operators' status as independent contractors.

The Supreme Court decision was followed by IRS guidelines written so that they can be easily understood and applied by examining agents as well as by motor carriers and independent operators. The overwhelming majority of employment tax cases involving the trucking industry have been resolved by reference to the guidelines.

The Internal Revenue Service concluded in its manual that the six factors give contract operators substantial opportunty for profit and loss and the risks of enterprise which are indications of independent contractor relationships.

If the Service applies the guidelines fairly and consistently, there would be no need for legislation insofar as the trucking industry is concerned. However, we believe that there has been some movement by the Service away from the stability provided the industry by the guidelines. Shifting determinations by the Service in other industries are the source of the problem.

In testimony before this committee in 1979, the Treasury Department portrayed a picture of widespread noncompliance in the reporting of income and the payment of income and Social Security taxes with respect to revenues received by independent contractors.

The Treasury's testimony was based upon an IRS compliance study undertaken in the last part of 1978 and 1979. Of significant concern to us was the fact that while the results purported to apply to all independent contractors, the sample from which the study was drawn consisted of those persons whom the Service had proposed to reclassify from independent contractors to employees.

In mid 1981 the GAO sent to Congressman Rangel its reports on its study of the characteristics of persons reporting and not reporting Social Security self-employment earnings. The study reported that 88.7 percent of truck drivers out of a universe of 190,000 reported their tax income. The study noted 11.3 percent that did not report had an average SECA tax liability of $309. It should also be noted that the study concludes that taxpayers having a self-employment earning of $50,000 and over have a 90 plus percent SECA compliance level.

We should note that in table 1 attached to the Treasury's 1979 written statement it was reported that where the independent contractor's amount of compensation was $50,000 and over, the percentage of compensation reported for income tax compliance was 98.4, while the percentage of SECA tax paid was 66.

That table also noted that for that compensation level the percentage of payees with full income tax compliance was 92, while compliance with some or all of the SECA tax was 66.7 percent.

We cite these figures since a study that was undertaken showed a profile of the independent operator as receiving compensation of about $55,000 per year. The profile showed that the independent operator's average operating expenses totaled $39,000 resulting in his having remaining disposable income of $16,000.

To these operating expenses the Treasury Department had proposed to add as an expense an additional 10 percent of the independent operator's gross revenue. Clearly the independent truck operator would not owe in taxes anywhere near the equivalent of 10 percent of his gross revenue.

H.R. 6311 proposes alternative standards for determining who is and who is not an employee for employment tax purposes. Information reporting requirements for payment of remuneration for services are increased and there are new penalties for failure to comply with the information reporting requirements and effective dates for the proposals with transitional rules. We support this bill, sir.

Another bill before you is H.R. 5867. In the strongest possible terms we oppose the withholding tax provisions of that bill. We strongly oppose its place of business, assets, sales and the income fluctuation standards because they ignore the rules long established for our industry by the Supreme Court and the Service.

The status of independent contractor or employee has been and should continue to be one of choice. It should be based upon the contractual agreement of the parties. What is at issue is the continued existence of the independent truck operator as a vital, viable and productive part of the motor carrier industry.

We urge enactment of H.R. 6311.

Thank you, sir.
[The prepared statement follows:]

STATEMENT OF DUNCAN MCRAE, JR., ON BEHALF OF THE AMERICAN TRUCKING ASSOCIATIONS, INC.

SUMMARY

The independent truck operator is an independent businessman, in control of his own destiny. He is the classic example of the American dream of owning your own business—working for yourself—and, therefore, is the prototype small businessman.

He is a vital segment of this country's motor transport system, which depends upon the independent operators' entrepreneurial spirit. Their historic status as independent contractors must continue unimpaired.

The trucking industry has found the common law to be instructive in determining an independent operator's status as an independent contractor. We agree that the common law in this regard should not be tampered with. H.R. 6311 maintains the integrity of the common law rules through its no inference clause.

The trucking industry is fully aware of the attack by the Internal Revenue Service during the 1970's upon the small businessman's status as an independent contractor. To remove the uncertainties caused by those attacks, we support the legislative effort to establish statutory "safe harbor" rules based upon the common law, in addition to retaining the common law. Any safe harbor tests that are adopted must take account of the operating practices of the trucking industry, particularly those imposed upon the industry by Federal and State law and regulations. In this regard, we support the provisions of H.R. 6311, although we suggest some general changes that we believe are necessary to make the proposals more clearly reflective of the common law test.

In the strongest possible terms, we oppose the imposition of any withholding tax on payments received by independent truck operators from motor carriers with whom they contract.

A survey made of a limited, but we believe representative, number of members of the American Trucking Associations, Inc. supports the conclusion that the independent truck operator is complying with his obligations under the tax laws. A recent report issued by the General Accounting Office supports this conclusion. Consequently, a withholding tax is unnecessary.

Furthermore, the withholding from the independent truck operator of a substantial portion of his gross revenue would, we submit, drive this independent businessman over the brink to financial disaster. This would be true even if he loses the use of a portion of his revenue only temporarily. His business is already severly strained by the inflation that has raged in this country in recent years, and the pricing policies of the oil producing nations. His operating costs have skyrocketd—estimated to be approximately 71 percent of his gross revenue. Withholding, even though temporary, will deprive the independent truck operator of desperately needed operating funds. If a withholding proposal was to be enacted, we submit that a substantial number of these small businessman would be forced out of business.

H.R. 6311 does not propose a general withholding tax. We, therefore, support the bill. We do not disagree with the limited witholding imposed when the parties fail to comply with their obligations under the tax law, although we suggest that such amounts should rightfully be cast as penalties, rather than a withholding tax.

We are firmly committed, as an industry, to the proposition that all should full meet their tax obligations. The reporting requirements of H.R. 6311 impose duties that we find our industry is meeting presently. We support the imposition of realistic penalties on those failing to meet their reporting obligations.

We recommend certain additional procedural measures for enactment. We have made recomendations of a technical nature for consideration by the Ways and Means Committee Staff; and we believe that examples of the application of H.R. 6311 should be included in the Committee's report on the bill.

INTRODUCTION

My name is Duncan McRae, Jr., and I am Executive Vice President of Melton Truck Lines, Inc., 1129 Grimmet Drive, Shreveport Louisiana 71107. I am accompanied by Edward N. Delaney, Washington, D.C., our special counsel.

We appear today on behalf of the American Trucking Associations Inc. (ATA), and we appreciate the opportunity to participate in the hearings of this Subcommittee.

ATA is the national organization of the trucking industry, a federation of associations in the 50 states and the District of Columbia, together with 13 national conferences which represent specialized types of motor carrier operations. As such, we represent all types of motor carriers of freight, both for-hire and private.

We urge that the historic status of "independent truck operators" as independent businessmen, exercising their entrepreneurial spirit and talents, be continued.

Furthermore, we urge that the limited financial resources of these independent small businessmen not be further strained by imposing a withholding tax upon their receipts, which they so sorely need to meet the great demands imposed upon them by inflation and the fuel crisis, as well as other economic burdens.

The effectiveness of the motor transport system existing in this country today is in no small measure the result of the dedication of these "independent operators". This dedication comes from the fact that the "independent truck operator" is an independent businessman, in control of his own work habits, and to that extent in control of his own destiny.

The "independent truck operators" is the classic example of the American dream of owning your own business—"working for yourself"—and, therefore, is the prototype small businessman.

As the Subcommittee on Special Small Business Problems of the House of Representatives' Committee on Small Business noted (H.R. Rep. No. 95-1812, 95th Cong. 2nd Session, 1978): "Throughout the interestate motor carrier industry is a trucker who has been referred to as 'the last American cowboy'. The American public pictures him riding the range perched high in his cab, listening to country and western music. A close-up look at this adventurous trucker reveals an independent-styled small businessman who is working hard to earn a decent living for himself and his family."

Their continued existence as small businessmen, and the vitality of this country's motor transport system, which is so heavily dependent upon their entrepreneurial spirit, demands that the "independent truck operators" status as independent contractors, their historic status, be continued unimparied.

The monthly cash demand imposed upon an independent operator are substantial. These demands reflect his cost of investment, maintenance of equipment, operating expenses and, of course, the support of his family. To subject the receipts of these independent small businessmen to an additional substantial expense, in the form of a withholding tax, without an adequate showing of need for such withholding by the Internal Revenue Service, will drive thousands of these entrepreneurs over the brink to financial disaster and out of business, to the great detriment of the motor carrier industry and the country.

The trucking industry has found the common law to be instructive in determining an "independent operators" status as an independent contractor. We urge that the common law in this regard not be tampered with.

Nevertheless, we are fully aware of the attack by the Internal Revenue Service during the 1970's upon the small businessman's status as an independent contractor. Therefore, we support a legislative effort to establish certain so-called statutory "safe harbor" rules based upon the common law, in addition to the common law rule of Section 3121 of the Internal Revenue Code (Code), to determine an "independent operators" status as an independent contractor.

As we understand H.R. 6311, the independent truck operator would be entitled to rely upon the common law tests in determining his status as an independent contractor, or alternatively, make use of the "safe harbor" rules to establish his status. Furthermore, it is our understanding that the common law rules and the "safe harbor" tests are not mutually exclusive—an independent truck operator may use either in determining his status under the Federal tax laws.

It might be helpful to the Subcommittee if we briefly outlined the common law rules that have established the independent contractor status of independent truck operators.

INDEPENDENT TRUCK OPERATORS AS INDEPENDENT CONTRACTORS

For purposes of the Federal Insurance Contributions Act (FICA), section 3121 (d)(2) of the Code defines the term employee to mean any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee, if the contract of service contemplates that substantially all of such services are to be performed personally by such individual. An exception to this rule is that an individual shall not be included in the term employee if such individual has a substantial investment in facilities used in connection with the performance of such services, other than facilities for transportation. The "other than facilities for transportation" was not intended to, and does not, encompass transportation facilities when they are an essential part of a trade or business.

This definition is in effect incorporated into the Federal Unemployment Tax Act (FUTA) and the Collection of Income Tax At Source On Wages law (Withholding Tax).

Independent truck operators generally own their own power units (the tractor); a relatively small percentage lease this equipment from a carrier or a third party. In either case, the independent operators control their own day-to-day operations, subject to the regulatory requirements of the Interstate Commerce Commission (ICC), the Department of Transportation (DOT), and other Federal as well as state agencies. They are not supervised in their daily routine by the motor carriers. Many independent operators haul freight over long distances across the country. Some may go for many days or weeks with the only contact with the motor carrier being a telephone call to find freight to haul or to advise of delivery.

Some independent operators own one unit of equipment; others may own a fleet, sometimes including as many as twenty or more units.

In general, independent operators are compensated by an agreed division with the motor carrier of the revenue paid by the shipper for the haul, or by a formula which takes into account the weight of the freight and/or the miles driven. Most of the revenue paid to the carrier—usually from about 50 to 75 percent or more depending upon the commodities hauled or the equipment furnished by the independent truck operator—is paid to the independent truck operator pursuant to an agreement for the division of the revenue.

Independent operators bear their own operating expenses. It is important to note that these operating expenses are substantial, estimated in many instances to be at least 70 percent of the independent operator's gross revenue.

Independent truck operators provide all necessary labor. Many independent operators who own only one rig operate the equipment themselves, while some hire drivers. Independent operators who own a fleet of trucks may employ a substantial work force including drivers, drivers' assistants, mechanics, and office personnel.

In addition to labor expenses, major expenses borne by the independent truck operators in general include fuel and maintenance costs, finance costs, depreciation, collision insurance, highway tolls, state permit and license fees, and various Federal and state taxes.

The independent contractor status of independent truck operators for employment tax purposes was first challenged by the Internal Revenue Service in a series of cases in the 1940's. That controversy culminated in a Supreme Court decision, *Harrison* v. *Greyvan Lines, Inc.*, 331 U.S. 704 (1947), which recognized the independent operators' status as independent contractors. The Supreme Court's decision that these contractors are independent—but not the Court's adoption of an "economic reality" test—was expressly confirmed by Congress, which reaffirmed the "common law" test, in the 1948 and 1949 amendments to the Social Security Act. (S. Rep. No. 1255, 80th Cong., 2d Sess. 2, 4, 13, 16, 1948; H. R. Rep. No. 1300, 81st Cong., 1st Sess., 189-91, 202-04, 1949).

The Internal Revenue Service acquiesced in the treatment of independent truck operators as independent contractors until the early 1970's, when it again began to challenge the relationship in a number of cases. The actions taken by the Service in 1972 and 1973 with respect to the trucking industry could serve as a model of the treatment of other industry groups.

In 1969 and 1970, the Service had reissued three Revenue Rulings which were based upon Social Security Tax rulings which had been issued in the 1930's. The 1969 and 1970 rulings are Rev. Rul. 69-349, 1969-1 C.B. 261; Rev. Rul. 70-441, 1970-2 C.B. 210; Rev. Rul. 70-602, 1970-2 C.B. 225. Although these rulings did not address the currrent pattern of operations, Revenue Agents began to rely upon them in asserting that an employment relationship existed in a number of cases. Huge retroactive assessments were proposed against the motor carriers involved.

It was at this point that the National Office of the Internal Revenue Service adopted a procedural method designed to resolve the cases fairly and equitably, and without the need for extended litigation.

As a first step, the National Office solicited the submission of approximately a dozen cases for Technical Advice. The cases were selected to represent a broad cross section of the trucking industry. The Service studied the operations of the carriers and the independent operators engaged by them. Working in cooperation with trucking industry groups, the Service issued a set of Guidelines [Internal Revenue Manual 46 (10)(2)] by which agents were to determine the status of independent truck operators and carriers, and stated that there would be a "strong inference" of independent contractor status when these factors were present. The then-pending cases were resolved by reference to these Guidelines. Standard contracts between the carriers and independent operators were, in many instances, revised to make it clear that an independent contractor relationship existed in line with the Guidelines.

The Guidelines are written so that they can be easily understood and applied by examining agents as well as by motor carriers and independent operators. The overwhelming majority of employment tax cases involving the trucking industry have been resolved by reference to the Guidelines. The Guidelines have generally eliminated the turmoil caused by enormous proposed assessments and have enabled the independent operators and carriers within the trucking industry to go about their business with reasonable certainty that their independent contractor relationship will be respected for withholding and employment tax purposes.

The six factors identified by the Guidelines as creating a strong inference of the independent contractor status of the independent truck operators are: (1) The independent operator owns the equipment or holds it under a bona fide lease arrangement; (2) The independent operator is responsible for the maintenance of the equipment; (3) The independent operator bears the principal burdens of the operating costs, including fuel, repairs, supplies, insurance and personal expenses while on the road; (4) The independent operator is responsible for supplying the necessary personal services to operate the equipment; (5) The independent operator's compensation is based upon a division of the gross revenue or a fee based upon the distance of the haul, the weight of the goods, the number of deliveries, or a combination of these factors; and (6) The independent operator generally determines the details and means of performing the services, in conformance with regulatory requirements, operating procedures of the carrier and specifications of the shipper.

The Internal Revenue Service concluded in Internal Revenue Manual 46(10)(1)(4) that: "The [six] factor [set forth above] give contract operators substantial opportunity for profit and loss and the risks of enterprise, which are indications of independent contractor relationships. Economic factors alone, however, are not conclusive when the company meaningfully controls the details and means used by the contract operators. Such control do not include those which a carrier imposes upon its drivers in order to direct them as to the results to be achieved. For instance, a company rule that drivers report regularly or frequently in a prescribed manner to receive work assignments should not be considered significant. In addition, operating requirements imposed by governmental regulations requires that a carrier's name appear on the operator's equipment and, therefore, such identification is not evidence of company control."

THE PRESENT AND THE FUTURE

If, and so long as, the Internal Revenue Service (Service) applies the Guidelines fairly and consistently there would be no need for legislation insofar as the trucking industry is concerned.

However, we believe that there has been some movement by the Service away from the stability provided the industry by the Guidelines. We understand that the National Office of the Service had proposed in a Technical Advice memorandum involving a trucking case to find an employer-employee relationship, even though in substantially identical cases reviewed at the time when the Guidelines were issued the Service found that an independent contractor relationship existed.

Furthermore, there were some informal indications that the National Office of the Service was considering the issuance of a revenue ruling that would be a companion to Rev. Rul. 76-226, 1976-1 C.B. 322, but which would set forth certain facts and circumstances and conclude that the relationship involved was that of employer-employee rather than independent contractor. Rev. Rul. 76-226 applied the Guidelines and concluded that an independent contractor relationship existed, rather than an employer-employee relationship.

Shifting determinations by the Internal Revenue Service in other industries are the source of the problem. The "bracket ruling" concept—one finding an independent contractor relationship and another finding an employer-employee relationship—created a vast area of uncertainty in other industries, and resulted in the creation of a substantial number of controversies rather than putting cases to rest. While a "companion" ruling involving the trucking industry would not necessarily have the same effect there is a potential for substantial confusion.

Consequently, the legislative enactment of "safe harbor" rules—rules that take account of the operating practices of the trucking industry including the moving industry—has the strong support of the trucking industry.

COMPLIANCE ISSUE

In oral and written testimony presented to a Subcommittee of the Ways and Means on June 20, 1979, the Treasury Department portrayed a picture of "widespread non-compliance" in the reporting of income, and the payment of income and social security taxes with respect to revenue received by independent contractors. The statement of Assistant Secretary of the Treasury Lubick alleged that ". . . at least 47 percent of workers treated as independent contractors did not report any compensation in question for income tax purposes. An even greater percentage, 62 percent, paid none of the social security tax due on their compensation."

Zero compliance in the trucking industry, according to the then Treasury study, was alleged to occur at the rate of 54.2 percent with respect to income tax, and 64.9 percent with respect to SECA taxes. Mr. Lubick also testified that "the IRS estimates that fewer than 60 percent of the required information returns for nonemployee compensation are actually filed."

The Treasury's testimony was based upon an Internal Revenue Service compliance study undertaken in the latter part of 1978 and early 1979. In our testimony before that Subcommittee we expressed substantial reservations about the validity of that study, not only in its results but in its methodology as well. Of significant concern to us was the fact that while the results purported to apply to all independent contractors, the sample from which the study was drawn consisted of those persons whom the Service had proposed to reclassify from independent contractors to employees.

While the number of individuals comprising each industry group was provided in the base data, it was not clear whether or not the individuals were properly classified in their industry category, or within subgroups within a particular industry. It should also be noted that those cases which did not contain enough information to provide what the Service considered a "reasonable possibility of follow-through" were dropped from the study.

While the implication was left with the reader of that report that the persons who could not be located deliberately failed to submit returns and pay their taxes, our view was that such inference was grossly unfair based upon the information provided in the study. For many years, the Service consistently refused to adopt a change of address form that taxpayers could submit to inform the Service of their change of location. The Service consistently uses the address on the tax return they are reviewing, which in most cases is two to three years old. In our mobile society, it is not at all unlikely, as the GAO pointed out in its July 11, 1979 report on "Who's Not Filing Income Tax Returns?", GGD-79-69, that taxpayers have moved from one location to another within that time frame—and moved for economic or family reasons—not for the sinister purposes implied by the Service's compliance study. In this regard, we also note that the United States Postal authorities maintain the change of address forwarding service for only one year.

The Service's background data with respect to that study shows that 700 taxpayers comprised the "trucking" category of the study. But, only 396 of those taxpayers were "drivers"—independent truck operators. Nevertheless, the Service's study indiscriminately implies that the alleged noncompliance percentages present a valid portrayal of the independent truck operator. We submit that this is simply not so.

It is also interesting to note that the background data, at one point, indicates that there was insufficient information with respect to 148 of the 700 taxpayers involved—21.1 percent of the trucking category. Yet, later data seems to indicate that 64 of those taxpayers were subsequently found to have previously filed returns, and 7 were found not to be required to file.

We note these matters simply to show that important questions about that compliance study exist. The GAO looked into some of these questions.

In mid 1981, the GAO sent to Congressman Rangle, in his capacity as Chairman, Subcommittee on Oversight, Committee on Ways and Means, it report on its study entitled "using the Exact Match File for Estimates and Characteristics of Persons Reporting And Not Reporting Social Security Self-Employment Earnings". This GAO report is identified as HRD-81-118, July 22, 1981.

Chart 1 of the study reports that 88.7 percent of truck drivers out of a universe of 190,000 truck drivers reported their SECA tax income. The study also noted that the 11.3 percent that did not report had an average SECA tax liability of $309. It should also be noted that Chart 3 of the study concludes that taxpayers having a self-employment earning of $50,000 and over have a 90+ percent SECA compliance level.

A taxpayer's SECA income and tax is reported and calculated on a Form SE, which is attached to, and made a part of the taxpayer's income tax return, Form

1040. It would strain credulity to argue that a taxpayer would report his or her SECA tax liability, but fail to report income for income tax purposes.

We submit that the earlier Service compliance report is seriously, and fatally flawed, as shown by the recent GAO report.

In an attempt to determine the reporting activities of the payors in our industry, we did undertake to question some of our members. We sought this information from seventeen of our members from various gross income groups, who were geographically dispersed. While we do not claim that our survey was scientifically structured, nevertheless, we feel the results are illuminating.

Sixteen members responded, all of whom said that they filed Form 1099 with respect to payments to independent operators who had transported freight for them. It is also important to note that all of the respondents voluntarily provided copies of the 1099's to their payees, even before this requirement was enacted into law in 1981. In our opinion, this is a more accurate reflection of what our industry is doing than is the Internal Revenue Service Compliance study.

We should note that in Table 1 attached to the Treasury's 1979 written statement it was reported that where the independent contractor's amount of compensation (as corrected) was $50,000 and over the percentage of compensation reported for income tax compliance purposes was 98.4 percent, while the percentage of SECA tax paid was 66 percent. That table also noted that for that compensation level the percentage of payees with full income tax compliance was 92 percent, while compliance with some or all of the SECA tax was 66.7 percent.

We cite these figures since the survey we undertook, albeit unscientific, showed a profile of the independent operator as receiving compensation in excess of $50,000 per annum. In addition, one carrier, who contracts with approximately 800 independent operators during the course of a year, constructed a profile of the average operator. This demonstrated that the average annual amount of compensation received by the independent operator was $55,000.

The results of these studies support our concern about the validity of the statement by the Treasury Department with respect to the alleged noncompliance by the independent operators of the trucking industry; our concerns have been validated, we submit by the most recent GAO study.

WITHHOLDING TAX AND REPORTING

In its Report on The Regulatory Problems of the Independent Owner-Operator In The Nation's Trucking Industry (H.R. Rep. No. 85-1812, 95th Cong., 2d Sess., 1978) the Subcommittee On Special Small Business Problems of the Committee On Small Business concluded that the independent operator is a "vital segment of the motor carrier industry."

If this vital segment of our industry is unable to meet the very high fuel and other costs it faces, it will cease to exist, to the great detriment of the country. It is critical to note that what is at issue is not what the independent operator's margin of profit should be, but rather, and more importantly, whether the independent operators will be able to meet their increasing costs in order to survive in business.

The plight of the independent operator in meeting his costs was recognized by the Subcommittee on Special Small Business Problems which described it as a "continuing cost crunch . . . [resulting from such factors as] . . . the cost of equipment [which] alone has almost doubled in the past few years, and the cost of fuel [which] has in many cases more than tripled."

We believe that it is significant that the Subcommittee recognized the fuel problem in advance of the crisis with which the independent operators are presently confronted.

We estimate that on average, approximately 71 percent of an independent operator's gross receipts are consumed by fixed and operating expenses—fuel, maintenance, finance costs, depreciation, insurance, tolls, permit and license fees and operating taxes. The profile developed by the carrier referred to earlier showed that the independent operator's average operating expenses totaled $39,000, resulting in his having remaining disposable income of $16,000. To these operating expenses the Treasury Department has proposed to add as an expense an additional 10 percent of the independent operator's gross revenues. To take a further 10 percent from an amount of compensation that is already squeezed in meeting fixed costs and operating costs that continue to escalate as a result of inflation would be unconscionable.

Clearly, the independent operator would not owe in taxes anywhere near the equivalent of 10 percent of his gross revenue. With an adjusted gross income of $16,000, we would estimate that exemptions and deductions would reduce the average independent operator's taxable income to approximately $10,000, which would result in a maximum income and self-employment tax of $1,875. This liability would be further reduced if the owner-operator created a Keogh Retirement Plan or an Individual Retirement Account.

Given the fact of high fuel and other costs that make it increasingly difficult, if not impossible, for independent operators to continue operating, the additional burden of a withholding tax would further reduce their disposable income and imperil the continued and viable existence of this vital segment of our industry.

If the answer is that the independent operator could opt out of the withholding tax by simply filing a form with the Service, what purpose does this elaborate program serve?

We strongly object to any withholding proposal since the consequence will be the likely financial ruin of the independent operator.

While we have strongly opposed the imposition of a withholding tax upon the revenues of the independent truck operators, we have not, and do not, countenance taxpayers avoiding or evading their fair share of the tax burden imposed upon our citizenry. All must shoulder the financial burden of supporting our Government.

We have recommended, and supported, substantial increases in the penalties for failure to file information returns, and for failure to supply correct taxpayer identification numbers. We also support any reasonable additional reporting that can be useful to the Service in its work to improve compliance levels. H.R. 6311 takes full account of these needs. The penalty and reporting provisions of that bill are drafted specifically to take into account the issues that might arise in the independent contractor relationship.

The Treasury also urged at one time that the Congress consider correcting the disparity between the FICA and the SECA tax rates as a part of the broader issue of social security financing. We would not disagree with the suggestion for considering that matter. Nevertheless, the Treasury's allegation that " . . . independent contractors bear less than their fair share of the social security tax burden even when they report all of their income[.]" is, we submit, falacious.

The Treasury based its questionable conclusion upon the statement that: " . . . Although employees and independent contractors receive identical social security benefits, the social security taxes imposed on independent contractors under the Self-Employment Contributions Act (SECA) are lower than the social security taxes an employee must bear under the Federal Insurance Contribution Act (FICA). (Although one-half of the FICA tax is technically paid by the employer and one-half by the employee, in an economic sense the entire burden of this tax is borne by the employee.)"

The Treasury Department, regardless of Administration, has consistently failed to produce any empirical evidence to support the parenthetical sentence cited above.

Moreover, while it is true that the SECA tax imposed on the independent contractors is approximately seventy-five percent of the combined employer and employee FICA tax, the employer is entitled to claim a deduction under the general income tax rules for the FICA. The employer, of course, receives a tax deduction for the entire amount of compensation paid to the employee. We understand that the net effect of this tax treatment is that the total burden differential is less than one percent.

LEGISLATIVE PROPOSALS

There are currently pending before this Congress a number of legislative proposals which are directed toward clarifying the employment tax status of independent contractors and those who engage their services. These proposals are in addition to any consideration of a further extension of section 530 of the Revenue Act of 1978 (with or without a cutoff date).

Two of the bills, H.R. 6311, introduced by Congressman Gephardt, and S. 2369, introduced by Senator Dole, are essentially the same. Each seeks to amend the Internal Revenue Code of 1954 in order to clarify the standards used for determining whether individuals are or are not employees for employment tax purposes. They are general in nature and neither is directed to any specific industry. They provide elaboration on several of the standards; make clear that certain employee tax benefits will not be available to the independent contractor; provide for increased reporting requirements; and, impose substantial penalties for failure to comply with the reporting rules, which penalties were originally urged by groups representing independent contractors.

H.R. 4531, introduced by Congressman Conable, seeks to amend the Internal Revenue Code of 1954 to clarify the standards used for determining whether individuals are or are not employees for employment tax purposes, and includes many of the reporting and penalty provisions of H.R. 6311, and S. 2369. H.R. 4531 also provides a jurisdictional basis for the independent contractor issue to be litigated in the United States Tax Court.

H.R. 5867, introduced by Mr. Guarini, proposes certain standards for determining independent contractor status, and seeks to impose a flat rate withholding tax on payments made by service recipients. H.R. 5867 reflects the provisions of H.R. 5460 which was considered by this Subcommittee in 1979.

We will discuss H.R. 6311, S. 2369, and H.R. 5867 in more detail.

H.R. 6311 AND S. 2369

As we noted, there is no substantial distinction between H.R. 6311 and S. 2369. Consequently, we will direct our specific comments to H.R. 6311.

H.R. 6311 proposes alternative standards for determining who is, and who is not, an employee for employment tax purposes; information reporting requirements for payments of remuneration for services; increased and new penalties for failure to comply with the information reporting requirements; and, effective dates for the proposals with transitional rules.

We support the "safe harbor" test set forth in proposed section 3508(b) as being realistic, without being permissive of avoidance of tax obligations by individuals rendering service as truck owner-operators. The standards set forth take account of the historic independent contractor status of truck owner-operators. They meet the stringent tests that the Internal Revenue Service established for its audit manual guidelines—guidelines that the industry and the Internal Revenue Service have found to be supportive of the just claim of Government for its revenue, and understandable and administrable by both the industry and the Internal Revenue Service.

H.R. 6311 maintains the efficacy of the common law (Section 3508(d)), which we deem essential to any proposed legislation in this area. Furthermore, the bill is specific that its only area of impact is in the area of taxation (Section 3508(e)). This, we submit, is an essential provision.

We will submit to the Ways and Means Committee staff certain suggestions that we believe would clarify the statutory language proposed, as well as a recommendation with regard to coordination of the time for filing the notice of tax obligations with the notice of the amount of remuneration paid. These recommendations should not be deemed to represent a criticism of H.R. 6311, but rather suggestions that we believe would clarify and ease the burdens undertaken by the Government and the trucking industry. The American Movers Conference will submit separately the changes they consider necessary.

We submit that the trucking industry has in the past recognized its obligations with respect to reporting to the Internal Revenue Service. Therefore, we fully support the provisions of H.R. 6311 setting reporting requirements, and increasing the penalties applicable to the failure, without reasonable cause, of payors to meet their reporting obligations. We strongly support the provisions of proposed Section 6501(c)(8) establishing, in general, a six-year statute of limitations on the assertion of penalties for failure to timely comply with the reporting obligations.

We believe that the effective date provisions of H.R. 6311 are reasonable, and generally provide our industry with adequate time, assuming early enactment, to assure that we meet the requirements of the proposal.

H.R. 5867

As I have previously stated, the ATA opposes, in the strongest possible terms, and for the reasons set forth earlier, the withholding tax provisions of H.R. 5867.

We support increases in the penalty provisions of the Code for failure to comply with the Code's reporting requirements. While the increased penalties set forth in H.R. 5867 are essentially penalty provisions that we suggested, and we support those penalty provisions, we also support the provisions of H.R. 6311.

We are compelled to strongly oppose several of the safe harbor standards set out in H.R. 5867. The standards that we oppose are the Place of Business; Assets; Or Sales; and, the Income Fluctuation standard. We must oppose these standards since they ignore the rules long established for our industry by the Supreme Court of the United States, and the Internal Revenue Service under its Guidelines and rulings.

We respectfully submit that the standards of H.R. 5867 were developed under the misimpressions created by the Internal Revenue Service Compliance report which, as we previously noted, has been discredited by the subsequent report of the General Accounting Office.

Specifically, we oppose the Place of Business test since it ignores the common law and Internal Revenue Service rule that an independent truck operator need not have a place of business to qualify as an independent contractor. The test is even more offensive to the ATA in that it fails to specifically recognize the fact that the independent truck operator's principal place of business is the truck tractor. In this regard, H.R. 5867 is clearly a punitive provision seeking nothing more than to force the independent truck operator into an employee mode of operation, all to the great detriment of the trucking industry.

Similarly, the "assets" or "tangible property" test fails to recognize long-standing rules of the common law and the Internal Revenue Service. The failure of H.R. 5867 to recognize the well-accepted concept of leasing of capital assets in capital intensive industries is inexplicable and totally unacceptable.

In large businesses, the Congress has not eliminated leasing as a form of acquiring necessary capital assets. Why then does H.R. 5867, in effect, prohibit the small independent truck operator from acquiring necessary capital assets through the leasing mechanism?

Equally disturbing to the ATA and the independent truck operator is the failure of the asset test of H.R. 5867 to recognize many of the maintenance costs and the variable operating costs that the independent operator incurs in his business as constituting the furnishing of tangible property. This provision is incomprehensible—except from the point of view of those seeking to drive the independent truck operator out of business.

Furthermore, in the many discussions we have held with representatives of the former administrators of the Treasury Department, we have not had anyone explain in an understandable way what "one-third of the value of the service is attributable to tangible property" means.

For these reasons we strongly oppose the assets or tangible property test of H.R. 5867.

Members of Congress are continually extolling their support for the small businessman. Here, in the asset or tangible property test, the Congress has an opportunity to back up its words with legislative action. We urge this Subcommittee to support the asset test of H.R. 6311.

We oppose the "sales" portion of the second standard of H.R. 5867 since it is discriminatory in nature in identifying only three specific groups of sales representatives. Specific identification of groups is, we submit, not only discriminatory, but bad statutory drafting policy, particularly in the tax law.

We oppose the income fluctuation standard of H.R. 5867 because it fails to specify that the term "other output" includes the performance of services, and because of the increase of the percentage after one year from 90 percent to 95 percent.

The term "other output" requires the explanatory clause that it includes the performance of services, and requires elaboration so that it is clear that the term piecework is limited to its historic manufacturing concept. The 90 percent test is sufficiently stringent to exclude those who should not meet the test; 95 percent does not provide adequate leeway to take account of aberrations.

We strongly urge this Committee to adopt the income fluctuation test of H.R. 6311 with the modifications recommended by the American Movers Conference.

TRUCKING INDUSTRY RECOMMENDATIONS

We seek to assure that the independent contractor status of the motor carrier industry's independent truck operators, their historic status, be preserved.

We strongly oppose any proposal for a withholding tax on payments made in the course of a trade or business to an independent contractor for the reasons noted. Withholding proposals will not resolve the definition issue, and will not remedy the alleged compliance problem.

The status of independent contractor or employee has been and should continue to be one of choice. It should be based upon the contractual agreement of the parties. What is at issue is the continued existence of the independent truck operator as a vital, viable and productive part of the motor carrier industry.

If an independent operator is unable to meet the test necessary to have the status of an independent contractor, it should be by choice. If an independent operator is unable to satisfy the test to qualify as an independent contractor, where historically he has been able to satisfy the test, it should be the exception rather than the rule. If an independent operator is unable to satisfactorily demonstrate compliance with the independent contractor test, it should not be because the test fails to take account of governmentally imposed burdens with which the regulated parties have no choice but to comply; where conflicting burdens do exist the test should recognize this. The enactment of legislation which fails to consciously address these general problems, applicable to any industry, will fail to preserve the historical status of independent businessmen, and to eliminate confusion, hardship and inequitable treatment.

We recommend the enactment of H.R. 6311. We restate our position that Congress must enact safe harbor criteria whose application is not such that bona fide independent contractors might not be able to satisfy the strict requirement of the bill.

We further urge, of course, that the common law rule be retained, even with the enactment of the safe harbor provisions, as H.R. 6311 provides. Thank you.

Chairman STARK. Mr. Golden, you would like to follow.

STATEMENT OF G. ZAN GOLDEN, SENIOR VICE PRESIDENT, NORTH AMERICAN VAN LINES, INC., ON BEHALF OF THE AMERICAN MOVERS CONFERENCE

Mr. GOLDEN. I am Zan Golden, senior vice president of North American Van Lines.

My written statement is submitted for the record on behalf of the American Movers Conference. I am accompanied here by Cliff Massa, counsel for the conference's tax policy committee.

I want to emphasize in addition to supporting the comments made by Mr. McRae on behalf of the American Trucking Association, one item in particular, relative to H.R. 6311.

While H.R. 6311 provides a series of standards which generally reflect the common law and IRS guidelines on independent contractor status, AMC recommends an elaboration on the language for the income fluctuation test. This test requires that more than 90 percent of the remuneration must relate to service output exclusive of so-called piecework.

We understand that the intention is to apply a commonsense definition or description under which piecework means repetitive work that is in the nature of manufacturing or assembling, work that produces uniform and tangible products, and work that is paid for on a unit basis.

However, because there is no applicable definition or descriptive language, we are concerned about the potential applicability of the term to what we call accessorial services on the moving job. These services consist of packing goods in containers, unpacking those goods, handling bulk articles such as boats, automobiles, and pianos, and other items that do not lend themselves to being included in the overall tariff schedule based on distance and weight or volume. Therefore, they are priced on a unit or hourly basis.

While the amount and content of such services vary from job to job, they are an integral part of transporting household goods shipments from one location to another.

In my written statement I note some statistical industry studies which indicate that in many instances such activities can account for more than the 10-percent leeway which is allowed in the income fluctuation test.

Therefore, it is particularly important to the household movers, and particularly to the motor carriers and their independent contractors who will generally perform more of such services, that the meaning of piecework not be misinterpreted subsequently to include anything other than the commonsense definition. While technical in nature, this matter requires correction in the proposed test.

There are two additional tests that need clarification:

First, the control of hours standard notes that an operator is not treated as not controlling the scheduling of certain hours simply because of coordination of services by another person unless that person is a related party.

Committee report language must clarify that activities such as those performed by a vanline dispatcher in consolidating loads for the contract driver or by an agent coordinating scheduling at trade shows are not tainted as coordinated.

Second, the investment in assets standards requires an asset that is of significant value in the performance of the service and that the investment in it is a substantial economic investment in light of the nature and amount of remuneration.

Committee report language should be clarified that an older depreciated truck used by the very efficient operator does not fall victim to a mechanically applied ratio comparing its current value to the related income.

Nonproductive actions and absurd economic consequences could ensue from failure to avoid misunderstanding on these three points. A need for clarification is clearly indicated.

The American Movers Conference is opposed to H.R. 5867. As is detailed in my written statement, we find that the safe harbor standards to be either difficult to apply, such as for the investment in assets or for piecework in income fluctuations, or discriminatory, such as by explicitly including certain sales activities while omitting our operators who historically have been treated as independent contractors by the courts and by the IRS.

Furthermore, we do not support withholding in any form. We recommend rejection of this bill in favor of H.R. 6311 with clarification.

Thank you, Mr. Chairman.

Chairman **Stark**. Thank you very much, Mr. Golden.

[The prepared statement follows:]

Statement of G. Zan Golden, on Behalf of the American Movers Conference

SUMMARY OF PRINCIPAL POINTS

1. The American Movers Conference endorses the general statement submitted for the hearing record by Duncan McRae, Jr., on behalf of the American Trucking Associations.
2. The particular history and structure of the household goods moving industry very clearly illustrates the nature of the contract truck operator as an independent contractor. Any legislation in this area must maintain clearly this longstanding treatment by the courts and the Internal Revenue Service.
3. The American Movers Conference generally favors the safe harbor standards contained in S. 2369 with recommended changes to reflect more clearly the common law and established guidelines of the IRS as they have been applied to our industry. Of particular concern is more specific language regarding "other output" in the income fluctuation standard.
4. The American Movers Conference vigorously opposes imposition of a withholding tax on the contract operator.

STATEMENT

My name is G. Zan Golden. I am Senior Vice President of North American Van Lines, Inc. My statement is submitted for the Subcommittee's hearing record on behalf of the American Movers Conference (AMC) in my capacity as a member of its Executive Committee and chairman of its Tax Policy Committee. The AMC represents approximately 1,000 member firms whose underlying network of some 5,000 movers and 25,000 independent truck operators provide more than 90 percent of this country's interstate household goods moving services.

The AMC is a member of the American Trucking Associations (ATA), and we share the general policy views and recommendations of the ATA as submitted to the Subcommittee in the written statement of Duncan McRae, Jr. Our statement is submitted to elaborate on the unique circumstances of the household goods moving industry as they relate to the issue of independent contractor status and to recommend specific changes in addition to those in the ATA statement.

The household goods moving industry

The household goods moving industry has a long history as a breeding ground for small independent businesses. In fact, our industry remains one composed almost entirely of small firms that are effectively linked together through both small and large van lines to provide the most efficient use of resources to serve the consuming public.

In earlier days when our society was less mobile and a typical long distance move might only have been into the next county, our industry was composed of a number of small motor carrier companies that undertook short distance moving. The local mover would transport a family's belongings across town or into the next county or perhaps to a large city. But the long distance move was infrequent. To the extent that cross-country moves took place, they were handled by the railroads in "pool cars" or as "immigrant moveables."

After World War I had shown more of the country to those in the Armed Services, and as the economy's labor force became increasingly mobile, the moving industry began to undergo a profound change. While the local move remains a significant part of the business, the long distance interstate move became more and more important. This gave rise in the late 1920's and early 1930's to the "backhaul bureau" which sought to link a local mover with a network that could efficiently allow him to move one family a great distance one way while improving his prospects of getting another load when he was ready to return home, even consolidating two or more loads on the same van. This restrained the cost of long distance moving by reducing or eliminating the mover's risk of "deadheading" or driving home with either a partially filled or an empty truck. By 1935, when the moving industry was brought under regulation by the Interstate Commerce Commission (ICC), these bureaus were already emerging as the modern van lines.

Currently, there are approximately 3,000 households goods carriers certified by the ICC, and perhaps 98 percent are small businesses under the Small Business Administration regulations. There are approximately 8,000 local community movers located throughout the United States. Most of these movers are tied together by a contract with a van line or carrier possessing broad interstate authority. Nearly all of these 8,000 are small businesses. When they contract with van lines, they are known as agents and provide local services for the certificated carrier, such as packing, unpacking, and intransit warehousing. Additionally, some of these local community movers have interstate authority for a region of the country. As a result, community movers may have a certificate to move household goods either under their own authority or as an agent for a van line. Finally, small van lines will interline with one another so that the independent truck operator will be transporting household goods under the certificate of two or more van lines.

Thus, the primary function of large and small van lines was originally, and still remains, to tie together a network of small movers who live in, and operate from, all areas of the country. It is through the coordination of thousands of small independent operators that our industry provides services to the American public.

It is noteworthy that some years ago when the ICC was the recognized model for solving economic regulatory problems, it appraised the moving system structure in depth, recognized that it is a creature of free enterprise, not regulation, and found it to be an efficient and effective apparatus to accomplish its purposes. The Commission then recommended to the Congress that it be relieved of certain of its policing functions relative to the structure of the industry, functions it declined to exercise in any event.

The contract operator

In line with this philosophy and in recognition of factors such as the interrelated character of the local, intrastate, and interstate elements of the moving industry, the highly seasonal nature of the traffic, and the historical method of augmenting equipment with the use of independent contractor truckers and agent lease equipment, the ICC has from the beginning shaped its leasing rules to accommodate the provision of adequate service by this broad-based and intricate system of transportation.

The van line may make a long-term lease (cancellable on a minimum of 30 days' notice to accord with ICC rules) with an independent contract trucker. Generally, although not necessarily, the van line provides the specialized trailer equipment. On the other hand, the van line agent may contract with the independent driver, provide the specialized equipment, and lease the entire rig to the van line on a long-term basis. In both instances, the equipment becomes a part of the carrier's permanent fleet. Additionally, the agent may contract with the independent trucker for service in its local or regional operations and may lease the entire rig to its principal carrier on a trip or intermittent basis. Again, this is all in accord with the Commission's specialized leasing rules for household movers. With the flexibility thus provided, we may have as many as 30,000 independent contract operators transporting household goods interstate during the three peak summer months when 50 percent of the traffic moves. The basic contract cost to the van line for thus augmenting its fleet generally ranges from 50 percent to 70 percent of linehaul revenue, depending upon the amount of equipment provided in individual cases and whether on a long-term or intermittent basis.

Additional charges, or a portion thereof, for "accessorial" services, such as packing and unpacking containers, are passed to the performing agent or the truck operator. Charges for packing and unpacking are priced and charged on a piece or container basis, per ICC regulation. Other accessorial charges may be priced on an hourly, weight, distance or item basis. Accessorial charges may, for some shipments, constitute almost half of the total moving charges. The individual contract operator's compensation amounts may vary substantially depending upon his participation in these activities, and it may vary by shipment or over an extended period of time. Moreover, since the independent operator in the moving business is free to turn down, as well as to accept, a shipment offered by the van line, compensation may further fluctuate via telephone negotiation when services are needed to pick up or deliver shipments in more remote areas of the country, in situations where carrier scheduling has become a problem due to weather or mechanical breakdowns, or in other instances of potential diminished profitability.

Normally, however, when the compensation package is agreed to and the pickup and delivery dates are fixed, the operator is essentially on his own. Subject only to Department of Transportation safety regulations regarding hours of driving and rest, and ICC regulations relative to pickup and delivery and other customer matters, the contract operator earns a profit on a shipment determined by how efficiently, skillfully and carefully he or she handles the goods. The expenses are the contractor's responsibility. Fuel, maintenance, tolls, meals, lodging, local labor, insurance—all are costs that reduce the contractor's profit. Likewise, the purchase or rental cost of the tractor (and possibly the trailer and accessory equipment) are the contractor's to bear. Thus, both fixed and variable costs are economic facts that provide the contract operator with the incentive to make the most efficient use of his time and equipment.

In addition to the purely financial considerations, the contract operator in the household goods moving industry faces still another significant factor in his business—the relationships with people. While drivers for our colleagues in the freight hauling sectors generally deal with other business entities from their loading docks, the household goods contractor deals directly with the consuming public, and most do so in the consumer's most private area—the home. Uprooting a family and moving the goods in a household is a responsibility that weighs heavily on the contract operator. Not only must the contractor exercise great care in the loading, transporting and unloading (because he or she is generally responsible for all or some portion of any damages) but the contractor strives to provide courteous and thoughtful service because that performance reflects well or ill on the affiliated van line. Indeed, the contract operator's outstanding reputation for quality performance may generate specific requests for his or her particular services.

The most proficient of the household van operators, moreover, may not deal with the householder at all but rather with the curators of art museums, directors of trade shows and exhibits, or traffic managers for companies that manufacture computers, missile nosecones, or other high technology equipment where shipments are valued in the millions of dollars. Extensive security measures are often involved. Such operators may realize gross annual incomes of more than $150,000. The equipment required to produce that revenue is a well-maintained single-axle tractor. A twin-screw tractor generally is the equipment in common freight hauling, but it will produce substantially less revenue for the truck operator than even a smaller tractor will accomplish for the household goods operator. Despite some contrast in the worth of the asset, it is indisputably essential in both instances to accomplish the task undertaken.

Finally, the household goods contract operator, due to his or her extensive and demanding duties beyond the tailgate, must deal with more demanding regulations and paperwork than any other operator in the motor carrier industry. Since this was a subject of intensive study and separate legislation in the 96th Congress (Household Goods Transportation Act of 1980), we will not elaborate here.

In summary, the contract operators in the household goods moving industry are mobile versions of the small, independent businesses that are found in every community around the country. The operator determines his or her own work habits (subject to major regulatory restraints and shipper requirements), negotiates the price for his or her services, covers expenses from revenues, determines his or her own efficiency and productivity, and deals directly with the consuming public. Thus, while van lines are able to weave together the essential national networks, it is the small contract operator that truly provides the basic service, and in so doing, manages his or her own business in a highly skilled and demanding profession.

Independent contractor legislation

As noted in the ATA statement submitted for the record, contract operators in the trucking industry in general have been recognized as independent contractors under both the common law and Internal Revenue Service administrative practices. While we were disturbed somewhat by indications in the 1970's that IRS might change its practices, it did not. Because the contract truck operator has for so long been clearly seen as an independent contractor by the courts, we strongly believe that the IRS would not succeed in attempting to remake its basic guidelines or to change common law.

Congressional moratoria on changes in IRS policy have reinforced that status. However, Congressional consideration of various proposals to write statutory rules governing independent contractor status creates the possibility that clear common law treatment will be clouded by an inference that a new Code section expresses Congressional intent.

Our intense interest in the ongoing legislative controversy therefore is not to create new law but rather to preserve and protect a recognized system of independent contract truck operators, a proven structure that effectively and efficiently accomplishes a basic need in our society and in our economy. It was created out of free enterprise. Free enterprise would recreate it if it were not in place.

Legislative proposals for independent contractor standards

The American Movers Conference's position with regard to the numerous proposals for the enacting of statutory "safe harbor" provisions continues to be rooted in three principles: We firmly believe that common law and IRS procedures have correctly treated the contract operator of a truck as an independent contractor; during development of any legislation, we seek only to ensure that our contract operators maintain their longstanding status. We do not seek to expand or enhance that status; and we believe that it is essential for any legislation to state explicitly that it does not affect common law treatment and to provide "safe harbor" standards that clearly include the contract operator.

Briefly summarized, our interest in, and our willingness to support, a statutory resolution of this matter is contingent upon the clear inclusion of our contract operators who historically have been correctly classified as independent contractors.

H.R. 6311

The proposal by Representative Gephardt, Representative Conable, Representative Heftel and Representative Hance, H.R. 6311, provides a series of standards which generally reflect the common law and IRS guidelines. However, any "safe harbor" tests adopted must take account of the very specialized operating practices of the household goods trucking industry. Because some of the household goods industry's practices, particularly in the area of pricing for services, differ from those of the remainder of the trucking industry, we will focus on a primary concern in the proposed fluctuation of income standard and recommend appropriate clarification in the statutory language and accompanying Committee report. We will also raise for consideration other provisions on which further elaboration in the Committee report would ensure that they will be applied in a common sense manner.

Income fluctuation

The risk of income fluctuation, like the control of hours, is a primary characteristic of the status of an independent contractor. For the contract truck operator, his decisions regarding which shipments to accept and his management of time and expenses will determine his net income for the year rather than simply the number of hours that he works.

While H.R. 6311 recognizes the significance of this factor by its inclusion of the test, a problem arises with the test as drafted due to the minimum amount—namely, more than 90 percent—that must relate to service output exclusive of "piecework." The problem is the absence of a definition of piecework or of a delination of its application to individual moves, to a series of related services, or to any period of elapsed time. Our understanding in that "piecework" is intended to mean only repetitive work that is in the nature of manufacturing or assembling, that produces uniform and tangible products, and that is paid for on a unit basis. For the household goods mover, however, the potential uncertainty is of such significance that we strongly urge a statutory definition. Our concern results from both ICC regulation and industry practices under which the independent trucker performs, and shares in the remunerations from, various accessorial services which are priced on a unit or time basis.

These services, as the name implies, are accessory to any complete moving job. They are included in a job to varying degrees depending on the circumstances. They consist of packing goods into containers, unpacking those goods, performing extra pickups and deliveries, handling bulky articles such as boats, automobiles, snowmobiles, etc., piano handling, overtime loading and unloading, and extra labor services not otherwise specified but which may be requested by the customer. These services are priced by the piece, by the item, or on an hourly basis because they do not lend themselves to being included in an overall tariff schedule based on distance, weight, etc.

Based on industry studies for the three years 1978–1980, charges for such services in which truck operators might participate range from 12 to 14 percent of the carrier's interstate revenues for household moving. Charges for packing and unpacking alone average 9 to 10 percent. These are calculated separately because ICC regulations require that they be priced on an item basis, by size of the container. For our industry as a whole, the preponderance of these services are performed by agents rather than truck operators. But such practices vary widely among carriers. There are instances in which individual contract operators on an annual basis, or for particular contract periods, do in fact receive compensation from these services that equal or exceed 10 percent and thus fail to meet the "more than 90 percent" requirement in H.R. 6311. For example, in 1981 a low accessorial revenue-producing driver for North American received 5.4 percent of his compensation from this source of revenue, but on the high side another contract operator had 20.7 percent. It is probable, moreover, that any given truck operator will perform one or more moves involving substantial compensation of this type. Such is the nature of household moving.

Furthermore, the percentage factor and the schedule under which it may be priced can vary substantially not only because of the items included, but simply because the normal transportation ingredients of weight and distance vary dramatically from shipment to shipment.

Without a clear statutory definition, the IRS may attempt to treat these accessorial services as "piecework", and a contract operator may not meet this safe harbor standard if 10 percent or more of his revenue relates to accessorial services. Because of this potential for technical disqualification, wasteful policies to insure compliance may result. Contractors may be hesitant to perform complete moving services for individual householders for fear of being disallowed their appropriate tax status. Therefore, since this matter is of such potential significance to our industry, we urge that statutory language clearly state that "piecework" refers only to repetitive manufacturing or assembly or other production of uniform tangible items and not to service performance.

Additional clarifications

There are two provisions of H.R. 6311 that the AMC believes need elaboration in the accompanying Committee report and legislative history. Both are matters in which a common sense application of the language would cause no problem, but we urge that you take steps to ensure that only such an application is possible. (Reference are to paragraphs in proposed Code section 3508.)

Coordination of services.—The first safe harbor standard in paragraph (b)(1) requires that the individual control the aggregate number of hours worked and substantially all of the scheduling of those hours. This is a primary characteristic of the independent contractor, and it is an appropriate standard.

The special rule in subparagraph (c)(4)(C) elaborates on the control of hours standard by noting that the individaul shall not be treated as not controlling any scheduling of hours merely because such control is limited as a result of:

"(C) the coordination of the performance of the service with the performance of other services but only if such coordination is done by a person other than the service-recipient or a related person . . ."

For the household goods mover, who also may undertake for business customers the moving of specialized equipment and exhibits, there are circumstances in which the coordination of various services is essential to the efficient and successful completion of the move. These include the following: Dispatching for contract operators who handle multiple family loads along one long route; arranging for the contract operator to load and unload in conjunction with appliance and utility servicemen who must disconnect and connect appliances and who must package those appliances for safe moving; coordinating with exhibit directors regarding deliveries to and pick-ups from the exhibition hall of a trade show or convention; and coordinating the operator's arrival at an international border with the delivery of essential customs documents from the shipper.

Of necessity, van line employees and agents are involved in the coordination of such activities; they are the only persons who can provide needed guidance and planning for multiple loads, for utility hookups and for arrivals and departures from exhibit halls. Without such assistance, operators could not efficiently perform their services. Yet, under subparagraph (c)(4)(C), such coordination with the performance of other services apparently would taint the operator's scheduling of the affected hours because the van line or agent is the service-recipient or a related person.

We understand that the purpose of this provision is to deal with construction site circumstances, not with the service performed by contract operators who transport goods. Yet, the current language could be interpreted to disqualify much of the time of the mover who takes multiple family loads or who regularly accepts trade show and convention exhibit work. We would not expect the carrier's/dispatcher's development of multiple loads for one operator to be covered by the exclusionary clause for service recipient coordination, but clarification in the accompanying report language would be helpful.

Investment in assets.—The investment in tangible assets standard in paragraph (b)(3) is an alternative to the income fluctuation standard. It requires that the individual's assets be "of significant value in the performance of the service" and that the investment in such assets be "a substantial economic investment in light of the nature and amount of the remuneration received for the service."

For the household goods movers, the main investment in an asset is his truck, and, in limited instances, the trailer and accessory equipment. The mover will not generally need a truck that is as powerful as that used by the freight hauler. Therefore, his truck may be less expensive and possibly older. The latter circumstance results in a higher degree of depreciation. However, the household goods mover may generate both larger gross revenues and net income with his truck than is the case for the freight hauler.

Our recommendation is that the assets standard, particularly clause (b)(3)(A)(i)(II) that compares the investment to the nature and amount of remuneration, be described in Committee report language to indicate that the purchase or lease of a truck for moving household goods is a substantial economic investment. The most efficient and profitable operators should not be placed in jeopardy by the potential development of a mechanical ratio that could relate a depreciated economic value of the asset to remuneration.

Our desire is to prevent the possibility that van lines would be required to audit their operator's financial records and to tell certain operators that they must either invest more money in their truck or forego additional moves. This potential for intrusion into the day-to-day activities of the operator in order to comply with the safe harbor standard then poses a risk that the operator would lose his status under the common law tests. This contradictory situation highlights the problem with any standard that requires constant monitoring.

H.R. 5867

The proposal by Representative Guarini, H.R. 5867, is the proposal developed by this Subcommittee as H.R. 5460 in the 96th Congress. The safe harbor standards provided in H.R. 5867 do not reflect the common law and IRS guidelines that have preserved our operators' longstanding status as independent contractors. Our specific concerns relate to the standards regarding place of business, investment in assets, sales, income fluctuation and the withholding provisions.

Place of business.—A place of business standard is not particularly appropriate or useful. Independent contractors in general often will move from job to job to perform services and may only rent space as needed for specific purposes. For the contract truck operator specifically, the only "place of business" is the cab of the truck which is where both necessity and ICC regulations require his records be kept. Therefore, the H.R. 5867 standard, which requires a place of business that meets certain tests, is not acceptable.

Investment in assets.—As noted above, an assets standard is a particularly troublesome one with which to work. Capital intensity—and therefore investments in assets—varies widely among industries. Regrettably, H.R. 5867 provides an asset standard that is unclear as to its purpose and that would have an uncertain application to our contract operators. As one part of a three-item alternative standard (place of business/assets/sales), the asset test requires that, "more than one-third of the value of the service is attributable to tangible property furnished by the individual performing the service." What is meant here is unclear.

By definition, contract operators do furnish their own equipment, which is very expensive, costing on an average in excess of $50,000. Thus, to the extent that the requirement of a substantial capital investment is indicative of independent contractor status, (which it is), contract operators would meet this test, but for the arbitrary one-third limitation. In particular cases, it is problematical whether more than one-third of the value of the services is attributable to the tractor he owns, and it is not clear how this measurement would be made. For example, qualification for including leased assets in the one-third test depends upon the requirement that the asset be leased "for a period which is long term in relation to the useful life of the asset," a requirement which is subject to widely varying interpretations.

In addition, a specific provision would allow truck tractors leased from, or financed by, the moving company to be counted in the one-third test, only if leased or financed "on terms and conditions comparable to those available on the open market." Contract operators may obtain more favorable lease or purchase terms from the moving companies because the companies are able to pass on saving realized through fleet-rate purchases of tractors and more favorable interest rates available to larger corporate borrowers. Unlike the financing of automobiles, the financing of truck tractors for individuals is generally not handled by commercial banks, but rather by finance companies whose "open market" financing is often at maximum rates allowed by state usury laws. To assist contract operators in financing their tractors, the moving companies often pass along the more favorable terms which they are able to obtain.

The "assets" test of the H.R. 5867 is an attempt to establish an objective standard for determining whether an individual has a substantial investment in his business. The result, however, is an arbitrary percentage which does not take into account the realities faced by independent businesses. One might logically ask why this test would be satisfied by an investment of 33⅔ percent but not an investment of 33⅓ percent, or why a contract operator who is able to take advantage of superior purchasing power of a moving company to lease of finance this truck tractor on terms more favorable than he himself could obtain in the open market would fail to satisfy the test. A more meaningful test of substantial investment is whether the investment in tangible personal property is sufficient to produce income fluctuation and the opportunity to produce profit or loss. With respect to leasing or financing arrangements, the thrust of the provisions should be to avoid sham transactions. Accordingly, the standard should be geared to whether the leasing or financing arrangements has *bona fide* economic substance, rather than whether it satisfied the terms available on some hypothetical "open market." [1]

Exemptions from the place of business and assets test.—An individual who fails to meet either the "place of business" test or the "assets" test may satisfy the second safe harbor standard of H.R. 5867 by meeting the "sales" test. The sales test specifically excludes from the place of business and assets test three traditionally-recognized classes of independent contractors—insurance agents, real estate agents and direct home sellers of consumer products. The exemption of these three groups reflects an intention that their traditional independent contractor status be recognized despite the fact thay they may not have a place of business separate from that of the service-recipient or that they have no significant investment in personal property. This same principle should, a fortiori, be extended to truck tractor contract operators, traditionally recognized independent contractors who lack a fixed place of business but do make substantial investments in their tractors and other equipment.

---

[1] An "open market" standard for truck leasing and financing terms is difficult to ascertain. How does the open market measure the selling price of the vehicle, the down payment, the rate of interest, the term of the security instrument, all of which vary widely, each dependent upon the other, and essentially upon the credit rating of the buyer?

Income fluctuation.—The risk of income fluctuation, like the control of hours, is a primary characteristic of the status of an independent contractor. H.R. 5867 presents more serious problems regarding piecework and the percentage requirement than does H.R. 6311 since it raises the 90 percent requirement to 95 percent in future years.

Withholding.—The AMC strongly opposes a withholding tax on payments to independent contractors. As has been emphasized above, the contractor operator is an independent small business owner. His net income subject to tax is a function of his appetite for shipments and his management of time, money and expenses. To impose a withholding tax on his distribution of revenues would impose a tax that probably bears little relationship to the final tax liability of the vast majority of operators. A 10 percent withholding tax on gross receipts would in many cases fully eliminate a contract operator's margin of profit.

Summary

Any legislation enacted to provide safe harbor standards for independent contractor status should define those standards in such a manner as to ensure that they are at least as broad as IRS guidelines and the common law. Furthermore, such legislation should explicitly state that it is not a replacement for common law determinations.

H.R. 6311, with changes regarding specific points discussed above, is a statutory proposal that can accomplish those objectives. However, the changes are particularly important to the contract operators who are household goods movers.

The American Movers Conference urges that the specific changes be taken into account when legislation is reported.

H.R. 5867 is not acceptable.

Chairman **Stark**. Mr. Perry, you will have the last word.

STATEMENT OF MARK PERRY, DIRECTOR, GOVERNMENT AFFAIRS, OWNER-OPERATORS INDEPENDENT DRIVERS ASSOCIATION

Mr. **Perry**. I am Mark Perry, representing the Owner-Operators Independent Drivers Association of America, a national organization representing thousands of independent truck owner-operators in the 48 continental United States.

Our association would support legislation which would provide a safe harbor for independent contractors in the truck industry, and we ask that the House of Representatives pass legislation keeping in tact the common law test for determining independent contract status.

Traditionally, owner-operator tax status has been deemed through a long legislative and legal process to be that of an independent contractor. The independent contract status of truck owner-operators has been set forth by common law and by actions of the U.S. Congress.

In *Harrison* v. *Gray Van Lines,* cited by Mr. McRae, the U.S. Supreme Court ruled and established that for tax purposes independent operators of trucks were in fact independent contractors and should be considered as such by the Internal Revenue Service.

The U.S. Congress confirmed this decision in a series of legislative actions in the 80th and 81st Congressional sessions. However, those actions by both the Supreme Court and by the U.S. Congress have been challenged, ostensibly because owner-operator truckers have failed to pay the taxes due from the U.S. Government.

The solution to this problem—and we do not necessarily agree that such a problem does in fact exist—has been to propose a special withholding tax on truck owner-operators. We would strongly oppose such a move. Such a proposal, if enacted, would place an unbearable economic burden on the owner-operator and other small businessmen, a burden which would exacerbate what can only be termed an already critical economic condition in our industry.

In essence, reclassifying the owner-operator segment of the trucking industry in any other status except that of independent contractor would place in jeopardy the viability of those whom I here represent.

While it is not our purpose by supporting a safe harbor for truck owner-operators to accrue to them benefits that they might not otherwise have, we do believe their unique position in the economy, in providing essential services, as well as their rendering of purely independent services merits this committee's close consideration.

For these reasons we support the sum and substance of H.R. 6311, which we believe this committee should adopt, because it contains the traditional common law test pertaining to independent contract status.

A large percentage of owner-operators are single truck owners who expend thousands of dollars to enter and stay competitive in the trucking industry. By definition, the term 'owner-operator' refers to a trucker who buys, owns, operates and maintains his own equipment.

Owner-operators, constituting 100 percent of our membership, center their operation around their own ability to provide necessary services. Usually these single truck owner-operators keep their own books, retain no employees and operate their businesses from their place of business, most often the power unit of their truck-trailer combination.

Financing of their own equipment from revenues accounts for a large proportion of their overhead costs, but they must also pay for fuels, tires, add-ons and maintenance, the costs of which are all at this moment rising.

In summary, owner-operator independent truckers are more than just the last cowboys, as made legend in song and on television. They are independent businessmen whose success is determined upon their ability to provide their services consistently, safely and at competitive costs.

They determine their own hours of work, establish their own place of business, make substantial investments in equipment necessary to provide the services they offer, and operate under bona fide lease arrangements with carriers or through broker-arranged contracts to exempt agricultural shippers.

All of the above factors represent what we believe are adequate tests for determining independent contract status of owner-operators, tests that have been laid down by the Internal Revenue Service in Internal Revenue manual 46.

These tests are as follows: that he is responsible for its maintenance; that he bears his own cost of operation; that he supplies services usually reserved to him in his profession and that are implied by the fact that he owns such equipment; that his revenues are derived from bona fide lease arrangements and by the provisions of those arrangements; and that the independent contractor determines the scope of his service within existing regulations.

In our opinion, Mr. Chairman, H.R. 6311 would maintain these tests, and for this reason we believe it should be adopted by this committee.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF THE OWNER-OPERATORS' INDEPENDENT DRIVERS ASSOCIATION OF AMERICAN

Owner-Operator's Independent Driver's Association of America (OOIDA), a national organization representing thousands of independent truck owner-operators in the 48 continental United States wishes to make know its views on current legislation pending before this Committee and Committee's of the Senate which would define the status of independent contractors for tax purposes.

Owner-Operator's Independent Driver's Association of America would support legislation which would provide a safe harbor for independent contractors in the trucking industry and we ask that the House of Representatives pass legislation keeping intact the common law test for determining independent contract status.

Traditionally, owner-operator tax status has been deemed, through a long legislative and legal process, to be that of an independent contract. The independent contract status of truck owner-operators has been set forth by common law and by actions of the U.S. Congress. In *Harrison* vs. *Gray Van Lines* (331 U.S. 704) the U.S. Supreme Court ruled and established that for tax purposes independent operators of trucks were, in fact, independent contractors, and should be considered as such by the Internal Revenue Service.

The U.S. Congress confirmed this decision in a series of legislative actions in the 80th and 81st Congressional sessions. However, those actions, by both the Supreme Court and the U.S. Congress have been challenged, ostensibly because owner-operator truckers have failed to pay the taxes due from the U.S. government. The solution to this problem, and we do not necessarily agree that such a problem does in fact exist, has been to propose a special withholding tax on truck owner-operators. We would strongly oppose such a move. Such a proposal, if enacted, would place an unbearable economic burden on the owner-operator, a burden which would exacerbate what can only be termed an already critical economic condition.

In essence, reclassifying the owner-operator segment of the trucking industry in any other status except that of independent contractor would place in jeopardy the viability of those whom I here represent. While it is not our purpose by supporting a safe harbor for truck owner-operators to accrue to them benefits that they might not otherwise have, we do believe their unique position in the economy, in providing essential services, as well as their rendering of purely independent services merits this committee's close consideration.

For these reasons we support the sum and substance of S. 2369, which we believe this committee should adopt, because it contains the traditional common law tests pertaining to independent contract status.

A large percentage of owner-operators are single truck owners who expend thousands of dollars to enter and stay competitive in the trucking industry. By definition, the term owner-operator refers to a trucker who buys, owners, operates and maintains his own equipment. Owner-operators, constituting 100 percent of the membership of the association that I represent, center their operation around their own ability to provide necessary services. Usually, these single truck owner-operators keep their own books, retain no employees and operate their businesses from their place of business—most often the power unit of their truck-trailer combination. The financing of their own equipment from their revenues accounts for the large proportion of their overhead costs, but they must also pay for fuel, tires, addons and maintenance—the costs of which are all, at this moment rising. In summary, owner-operator independent truckers are more than just the "last cowboys" as made legend in song and on television. They are independent businessmen whose success is determined upon their ability to provide their services consistently, safely and at competitive costs. Owner-operators determine their own hours of work, establish their own place of business, make substantial investments in equipment necessary to provide the services they offer and operate under bona fide lease arrangements with carriers or through broker arranged oral contracts to exempt, agricultural shippers.

All of the above factors represent what we believe are adequate tests for determining the independent contract status of owner-operators, tests that have been laid down by the Internal Revenue Service in Internal Revenue Manual 46. These six tests are as follows: (1) That the independent contractor owns his own equipment; (2) that he is responsible for its maintenance; (3) that he bears his own cost of operation; (4) that he supplies services usually reserved to him in his profession and that are implied by his owning such equipment; (5) that his revenues are derivied from bona fide lease arrangements, and by the provisions of those arrangements and that; and (6) the independent contractor determines the scope of his service within existing regulations.

In our opinion, S. 2369 would maintain these tests, and for this reason should be adopted by this Committee.

Many have advocated the imposition of stronger penalties on those independent contractors who do not pay their taxes. We are mindful of the fact that we cannot here claim, at one and the same time, that we oppose the imposition of such penalties, while also claiming, as we do, that owner-operators do in fact pay their taxes.

On the other hand, we think that the U.S. Congress and the Internal Revenue Service would be setting a dangerous precedent by setting unreasonable penalties for non-payment. While penalties for non-payment are clearly called for, the essential services rendered by owner-operator truckers, and the non-permanence and continually moving nature of their business dictates that the federal establishment set payment penalties that are both fair and equitable, and that they take note of the fact that owner-operators, by the very nature of their business, are "transitory" businessmen. In essence, they go where the work is. This is especially true of owner-operators engaged in moving and it is true for exempt haulers.

Recently, I spoke with two truckers, both of whom operate their businesses out of their power unit. One was leased to a moving firm, one of the largest in the nation, while the other spent his time following the crops—so to speak. Both had residences, but neither had been home in a full three months. In the present economic environment, this is not unusual.

Compliance with tax laws is absolutely essential for the maintenance of the federal establishment, but the nature of the citizens occupation must be taken into account in determining penalties for non-compliance. We caution this Committee that penalties imposed in this area be such that they do not immediately threaten the livelihood of an owner-operator, and only become detrimental to his way of life, and means of earning income should he fail to consistently pay his tax obligation. Certainly, it is not the intent of the Committee, or of any member of the federal government to force independent contractors to become employees simply because that will make it easier to collect taxes. Such a policy not only bodes ill for owner-operators but for many small businessmen and businesswomen in the nation.

The Committee has asked that we respond specifically to socalled procedural questions in regard to independent contract tax legislation. In essence, our worry is that those not covered by such legislation would be faced with bankruptcy by any tax assessment. This is a jsutified concern. But we believe there is a common sense solution. Such assessments could be deferred, under certain circumstances, and the guidelines for such deferral could be noted in any bill passed by this Congress. If a business faces immanent closure due to its inability to meet its tax obligation, the U.S. Judicial system could rule an extension under the act.

Such procedural questions should not delay action on this important issue. Enactment of safe harbor provisions in our industry before the end of the moratorium is essential. The U.S. General Accounting Office noted recently, that of the 190,000 total truck drivers in the nation (there are certainly fewer now) a full 88.7 percent reported their SECA tax obligation and met that obligation. We believe that owner-operators do meet their obligations. The imposition of a 10 percent withholding fee would be a penalty imposed therefore without the commission of a crime. It would be unjustified and unprecedented in the annals of tax law. We as a nation have the highest percentage of tax payment of any industrial democracy. The vast majority of citizens of the United States pay their taxes voluntarily and on time because the trust they have placed in American institutions has not been betrayed. But placing a penalty on a class of American citizens by virtue of their occupation could erode this trust and perhaps imperil the tax system itself.

We support the substance of S. 2369 for this reason. Faced as our members are, by the welter of fuel taxes, highway taxes, permit regulations and tax surcharges, all required by a myriad of local jurisdictions and municipalities, they do not need to become the unnecessary victims of a well-meaning federal establishment. S. 2369 will provide owner-operators with a necessary safe-harbor under which they can conduct their business operations honestly, while providing them with a means of meeting their essential tax obligations. We ask for its adoption.

Chairman **Stark**. Thank you very much, Mr. Perry.

I want to thank the panel. I want to thank all of the witnesses who appeared here today for their cooperation.

All of the statements will appear in the record. The record will remain open.

The staff and members may have additional questions of the witnesses, and their responses will be made part of the record.

I want to thank the members of the subcommittee for their cooperation and the staff for the excellent job in preparing for this hearing today.

The subcommittee will stand adjourned subject to the call of the Chair.

[Whereupon, at 12:46 p.m., the hearing was adjourned.]

[The following was submitted for the record:]

[For delivery Apr. 26, 1982, before the Senate Finance Committee on S. 2369]

STATEMENT OF DANIEL F. STANTON, DEPUTY DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. Chairman and Members of the Subcommittee: We are pleased to be here today to assist your subcommittee in considering S. 2369, the Independent Contractor Tax Classification and Compliance Act of 1982. The bill seeks to resolve the issues which surround the classification of workers as either employees or self-employed for Federal tax purposes. These issues led to the Congress' imposing a 3½ year moratorium on employee-independent contractor determinations by the Internal Revenue Service (IRS). That moratorium is due to expire on June 30, 1982.

Our testimony is based primarily on work we have done in the past several years relating directly and indirectly to the subject of independent contractors. In late 1977, we issued a report which dealt with (1) the difficulties faced by employers and IRS in determining who is an employee and who is self-employed and (2) the problems associated with retroactive assessments against employers who IRS believed had misclassified employees as indendent contractors.[1] The report recognized the need and recommended standards for clarifying the classification rules so that businesses could more accurately make employee and self-employed determinations. In a 1978 report, we made various recommendations for improving IRS' audits of individual returns as they relate to the correct payment of social security taxes, particularly by self-employed persons.[2] In 1979 testimony before the House Ways and Means Subcommittee on Select Revenue Measures, we reaffirmed the need to clarify the rules for determining employer-employee relationships.[3] We have also reported and testified extensively on taxpayer compliance and the unreported income problem, including the problem involving independent contractors.

Mr. Chairman, we support the objectives and intent of S. 2369. It should ease the problems associated with classifying workers as employees or as independent contractors. Businesses will be able to make worker status determinations with more certainty and have less fear of unexpected and large retroactive tax assessments. In addition, the bill provides tools which should help IRS improve independent contractor compliance with the tax laws.

S. 2369, however, will not eliminate the need for IRS reclassifications and retroactive assessments, and problems associated with those actions will continue to exist. Therefore, some legislative and administrative changes will be needed, particularly to reduce the potential for double taxation. In addition, IRS will be faced with an increased workload generated by the information reporting provisions of the bill.

---

[1] "Tax Treatment Of Employees And Self-Employed Persons by The Internal Revenue Service: Problems And Solutions" (GGD-77-88, Nov. 21, 1977).

[2] "Additional IRS Actions Needed To Make Sure That Individuals Pay The Correct Social Security Tax" (GGD-78-70, Aug. 15, 1978).

[3] Statement of Richard L. Fogel, Associate Director, General Government Division, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, on Compliance Problems of Independent Contractors.

S. 2369 CLARIFIES THE PROCEDURES FOR CLASSIFYING WORKERS, BUT SOME RECLASSIFICATIONS AND RETROACTIVE ASSESSMENTS WILL STILL OCCUR

S. 2369 clarifies the standards used in determining if workers are employees or independent contractors for Federal employment tax purposes. While there are some differences between S. 2369 and the recommendations we made in 1977, S. 2369 accomplishes the overall purpose of clarifying the circumstances under which a worker should be classified as an employee of an independent contractor. The bill's safe harbor provision provides standards and tests for deciding whether a worker is an employee or an independent contractor for Federal tax purposes. We generally agree with the standards contained in the bill. However, the subcommittee may want to consider a modification to the test for ensuring economic independence.

S. 2369 requires that to meet the economically independent aspect of the safe harbor provision, a worker must either risk income fluctuations or have a substantial investment in tangible assets used in performing the service. We believe the income fluctuation aspect may be too broad. For example, any worker who gets paid commissions could have significant fluctuations in income. These workers may be employees under common law and yet qualify as independent contractors under the safe harbor provision of S. 2369, a result seemingly contrary to the intent of the bill. We suggest, therefore, that the income fluctuation test be replaced by a test of a worker's risk of suffering a loss as well as making a profit.

Although S. 2369 should result in fewer IRS reclassifications of workers and, thus, fewer retroactive assessments of employment taxes, some reclassifications and retroactive assessments will still occur. In this regard, while the bill's safe harbor provision provides greater certainty, there will no doubt be instances where IRS and businesses disagree on the applicability of the provision. Also, many cases will continue to be resolved under the common law criteria because some workers will not qualify under the safe harbor provision or will choose the option of common law as an alternative test. Thus, the problem of businesses being assessed retroactively—even if they had acted reasonably in making the worker status determination—will still exist, although on a smaller scale.

The likelihood of IRS reclassifications and retroactive assessments could perhaps be further reduced by Treasury's issuing timely and explicit implementing regulations after enactment of the bill. It is important that such regulations clearly define and explain the safe harbor provision and contain several examples of the applicability of the criteria.

When retroactive assessments are made, the problem of double taxation can exist in certain cases. Some legislative and administrative remedies are thus needed. Double taxation occurs when the employer and the employee pay taxes on the same income.

IRS cannot offset the employee share of Federal Insurance Contribution Act (FICA) tax with the amount of Self-Employment Contribution Act (SECA) tax the employee paid on the same income, unless the 3-year statute of limitations period has expired. Such an offset is authorized only if the employee is prevented by law from filing for a refund on the SECA tax paid in error.

Failure to offset can result in the employee portion of social security taxes being collected twice—once from the employer as the FICA tax he or she failed to withhold and once from the employee as SECA tax paid in error. This happens because the employees often do not know that they can file for a refund of SECA tax paid. The employer's portions of the FICA tax does not represent a double payment because the tax is paid for the first time when the employer pays the tax.

On the basis of our sample of cases closed in 1975, we estimated that at least 667 employers were assessed retroactively about $2 million in FICA taxes. Of this amount, $1 million represented the employers' portion of the tax. The remaining $1 million represented the employees' portion of the tax which the employer was responsible for withholding. To the extent that the employees paid their SECA taxes while improperly classified as self-employed, a double payment of social security taxes occurred.

For example, we analyzed 5 of the employer cases in our sample. These 5 cases involved 37 employees. Our analysis showed that 24 of the 37 employees paid SECA tax on the income earned while considered self-employed. IRS assessed the five employers $6,913 for the employees' portion of the FICA taxes due on wages paid to the 37 employees. Of this amount $5,008 (72.4 percent) represented a double payment of social security taxes to the Government. The amount of the social security taxes actually due the Government was $1,905.

To help alleviate this problem, we recommended in our 1977 report that the Congress amend Section 6521 of the Internal revenue Code to authorize IRS to reduce the employees' portion of FICA taxes assessed against employers by an appropriate portion of the amount of SECA taxes paid by reclassified employees for the open statute years. The Congress has not yet acted upon that recommendation. In the interest of equity, we still think it should.

In our 1977 report, we also recommended that to avoid double taxation IRS should use information in its files to adjust retroactive assessments. IRS opposed this recommendation contending that it would shift from the employer to IRS the whole burden of proving which employees had paid self-employment and income taxes and in what amounts. Our intent was not to shift to IRS the whole burden of proving which employees had paid SECA and income taxes. Rather, we intended that, in instances where employers had made reasonable but unsuccessful efforts to obtain employee certifications that the proper tax had been paid, the IRS agent would: (1) where possible and practical, obtain copies of tax returns for those employees from whom the employer was unable to obtain a certification; (2) make limited checks as to the taxes reported as paid by these employees; and (3) if justified on the basis of these checks, abate a portion of the employer's tax assessment.

We think our recommendation still merits consideration. We recognize that our recommendation would increase IRS' costs without producing additional revenue. Our concern in this instance, however, is more with the inequity of double taxation. Also, the cost to implement the recommendation should be less after S. 2369 is enacted. S. 2369 should reduce the number of reclassifications and retroactive assessments and, thus, the number of potential double taxation situations. This, in turn, should result in fewer cases that IRS would need to research.

S. 2369 SHOULD IMPROVE INDEPENDENT CONTRACTOR COMPLIANCE IF IRS CAN HANDLE INCREASED WORKLOAD

We also support S. 2369 because it should enhance independent contractors' compliance with the tax laws by emphasizing information reporting and providing penalties to ensure that the information reported is accurate and complete. However, the additional information reports and penalties will increase IRS' workload at a time when overall compliance is declining and IRS resources are not keeping pace.

Specifically, S. 2369 would expand existing information reporting requirements to include direct sellers who provide consumer goods to others for resale in the home on a buy-sell or deposit-commission basis. It also provides for stiff penalties for payers who fail, without reasonable cause, to provide the information reports to IRS or to the independent contractors. Additionally, the bill would authorize tax withholding when payees fail to provide the identification numbers IRS needs to match the information reports with filed tax returns.

As you know, Mr. Chairman, we have reported and testified extensively on the unreported income problem, including noncompliance by self-employed persons. On March 22, 1982, we testified before this subcommittee in support of S. 2198, the Taxpayer Compliance Improvement Act of 1982, which, among other changes, would increase and strengthen the use of information reporting applicable to areas other than independent contractors. We also support S. 2369 which is specifically targeted at independent contractors.

As with the information reporting requirements of S. 2198, however, S. 2369 will increase the number of information reports IRS receives, and IRS will thus have more reports to process and match against tax returns. That matching, in turn, could produce more unreported income cases to investigate. Both situations entail increased use of IRS resources which, as you know, Mr. Chairman, is a problem. In this regard, we have repeatedly stressed the importance of having payers submit information reports on computer tapes instead of on paper, and repeatedly supported the need for increased IRS resources.

S. 2369 also provides various penalties designed to ensure the accuracy and completeness of information reports. Although we support the need for tougher penalties, we would like to make an observation concerning the bill's penalty provisions. While we have not had an opportunity to consider all the administrative implications, the penalty surcharge provisions of the bill may be somewhat cumbersome and time-consuming to administer—and thus less likely to be fully enforced by IRS. In this regard, in our testimony on the penalty provisions of S. 2198, we pointed out that, while sufficiently high penalties are a necessary part of effectively promoting and enforcing compliance with information reporting requirements, IRS needs to more effectively identify and pursue payers who fail to submit all required information reports.

In conclusion, Mr. Chairman, we support S. 2369 and its principal concerns—clarifying the standards for determining worker status for Federal tax purposes, and improving independent contractors' compliance with the tax laws. we too think it is time to end the moratorium and provide more certainty for businesses in deciding whether a worker is an employee or self-employed.

Even with the bills's safe harbor provision, some reclassifications and retroactive assessments will still occur. In this regard, we suggest that the Congress consider our recommendation for a FICA-SECA offset to avoid the double taxation which may result in some of these instances.

Although the bill will increase IRS' workload at a time when its resources are spread thin, S. 2369, like S. 2198, would enhance IRS' efforts to deal with the tax compliance gap. Perhaps more important than any of their specific compliance provisions is the message S. 2369 and S. 2198 would send to the public—the Congress and IRS are taking tough measures to reduce tax cheating and the burden it places on honest taxpayers.

This concludes my prepared statement, Mr. Chairman. We would be pleased to answer any questions.

STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURANCE

This statement is submitted by the American Council of Life Insurance. The Council is the major trade association of the life insurance business with a membership of 524 life insurance companies which, in the aggregate, have approximately 96 percent of the life insurance in force in the United States and hold 97 percent of the assets of all United States life insurance companies. We appreciate this opportunity to comment on the issue of classifying workers, particularly life insurance salesmen, as either employees or independent contractors for employment tax purposes.

SUMMARY

We generally support the legislative initiatives which would amend the Internal Revenue Code to provide certain tests for determining the status of individuals for employment tax purposes. We believe that adoption of statutory objective standards which, if satisfied by an individual, will enable the individual to be treated as an independent contractor for employment tax purposes, will provide the certainty and uniformity that is essential to the effective operation of the employment tax laws. We oppose, however, the imposition of any withholding requirement on payments made to independent contractors because of the serious administrative problems associated with such a proposal.

BACKGROUND

Currently, Code § 3121(d)(2), with certain specific exceptions, defines an employee as "any individual who under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee." Basically, the common law is a set of factors based on court decisions and custom which is used to classify an individual as an employee or independent contractor.

The focus of the common law in this area revolves around the employer's right to control the way an employee works, both as to the final result and as to when and how that result is accomplished. (The IRS has adopted twenty factors to be considered in determining employment status.) In making this determination, no single factor is conclusive. Moreover, the degree of importance of each factor varies in each case.

Application of the common law rules to complex and changing business arrangements is very difficult and has produced inconsistent results. At best, a decision to go one way or the other as respects a particular relationship involves a significant degree of uncertainty as to how the IRS will react. These problems are particularly pertinent when attempting to classify a life insurance agent because of the myriad of arragements between agents and their companies that are used to market life insurance.

Despite the inherent weaknesses with the common law standard for determining whether an individual is an employee or independent contractor, the impression was created for many years that the common law definition of "employee" was a workable standard, since the IRS, until recently, raised few challenges regarding the employment tax status of individuals, including life insurance agents. During the past few years, however, (prior to the Congressional ban on IRS employment tax audits) the IRS had increasingly challenged the previously unquestioned employment tax status of workers in many industries and occupations, including the life insurance business. The experience of our member companies indicates that these employment tax audits appeared to involve a change of position by the IRS and, in some cases, a rejection by the IRS of prior private letter rulings issued to companies holding agents to be independent contractors. This increased audit activity and challenges substantially eliminated the predictability that at one time seemed to exist and made it clear that the common law definition is clearly too imprecise to be the primary test to be used in determining the employment tax status of individuals.

In order to provide an interim solution to the controversies that had developed in employment tax audits while Congress attempted to enact a substantive solution to the problem, the Revenue Act of 1978 contained a provision (section 530) which prohibits the IRS from reclassifying an individual as an employee for employment tax purposes for any period ending before January 1, 1980, if a business had a reasonable basis for treating such individual as an independent contractor. This ban was subsequently extended to June 30, 1982. In view of the approaching deadline, we agree with you, Mr. Chairman, that Congress must act quickly to enact substantive legislation setting forth appropriate and clear tests to be used in classifying individuals as employees or independent contractors.

LEGISLATION INTRODUCED TO DATE PROVIDES AN APPROPRIATE SOLUTION

H.R. 4531 (Rep. Conable), H.R. 4971 (Rep. Crane), H.R. 5729 (Rep. Gephardt), and H.R. 6311 (Reps. Gephardt, Conable, Heftel, and Hance) are all designed to provide a permanent solution to the problem of classifying workers for employment tax purposes. Each of these bills sets forth five requirements which, if satisfied, would result in a worker being treated as an independent contractor. If one or more of the five tests is not met, the individual's status will be determined, without prejudice, under the common law rules.

To fall within the safe harbor test set forth in these bills, an individual generally: (1) Must control the number and scheduling of hours worked; (2) Must not have a principal place of business or, if he has one, it cannot be provided by the person for whom the service is performed unless reasonable rent is paid therefor; (3) Either must have a substantial investment in the assets used in connection with the services performed or must risk significant income fluctuation; and (4) Must perform the services pursuant to a written contract that spells out his status as an independent contractor and the tax obligations associated with that status. Moreover, the person for whom such service is performed must file all information returns required with respect to such service.

We believe these bills provide an appropriate approach for clarifying the employment tax status of individuals, including life insurance agents. The requirement set forth in these bills are, in our view, an appropriate dividing line. The tests can be easily applied and will provide the certainly and uniformity that is so necessary if our tax laws are to work efficiently and effectively.

It has been argued that this type of approach would permit workers, including life insurance agents, to be treated as independent contractors. This implies, of course, that without a bill of this type, life insurance agents would be treated as employees. It ignores the very real controversy that has developed over recent years and which lead to the stopgap legislation passed by Congress and Congressional efforts to come up with a rational and administrable set of guidelines.

The possibility of "manipulating" an employer-employee relationship to meet the requirements of this type of legislation has also been cited as a reason for opposing bills of this type. There is a strong implication that such "manipulation" would be for tax-avoidance purposes. For whatever reason, if an employer and an employee rearrange their working relationship so as to meet the independent contractor criteria, that change should be recognized—it is more than mere manipulation. The real issue is whether the criteria are correct, and we believe they are.

STRENGTHENING INFORMATION REPORTING REQUIREMENTS

H.R. 4971 and H.R. 5729 also require that the person for whom service is performed must file all information returns required with respect to such service. H.R. 4531 and H.R. 6311 have this requirement as well but also contain recommendations, with which we agree, for strengthening the information reporting system. We believe payees should be given a copy of any information return field with the IRS so that there is no doubt about the amount of compensation to be reported by them. Moreover, to assist the IRS in its enforcement function, we suggest that the information return be required to be attached to the individual's tax return, as is currently the case with Form W-2.

In addition, we do not object to the proposal to increase the penalites for failure to file an information return with the IRS and to supply this penalty to the failure to furnish such return to the payee.

WITHHOLDING REQUIREMENT

H.R. 5867 (Rep. Guarini), in addition to providing a statutory safe harbor for determining when an individual would be classified as an independent contractor, would impose a flat 10 percent rate of withholding on payments made to independent contractors. We strongly oppose the imposition of a withholding requirement in this area.

The withholding proposal results from the alleged high rate of noncompliance by independent contractors with regard to the payment of Social Security tax (SECA) and income tax. We are pleased to note, however, that recent government statistics indicate an extremely high degree of compliance by the life insurance business; only 1.7 percent of all the compensation received by life insurance agent is not being reported. Thus, as a general matter, we do not believe it is necessary to subject life insurance companies and their agents to the complexities, burdens and costs that would be involved in implementing the withholding proposal contained in H.R. 5867.

The withholding proposal presents severe administrative problems for our members. The fault with the proposal is that it is much more pervasive than it appears on its face and, if adopted, will require payors, in even the most casual transactions, to either be the collecting agent for the Government, often resulting in overwithholding, or to process massive amounts of paper to establish that withholding is not required. We question whether it is appropriate to place these burdens on payors.

More specifically, we believe the withholding proposal will result in an administrative nightmare. A life insurance company hires many independent contractors to perform specific functions that are necessary to the operation of its business. For example, a company may hire doctors to perform physical exams on potential policyholders, consultants to give advice on specific subjects or service people (painters, plumbers, electricians) to handle problems with the building which houses its offices. Our members will not, as a practical matter, rely on the reasonable cause exception to withholding but rather will require a certificate from the individual either indicating (1) that the individual performed or will perform similar services for 5 or more unrelated service recipients or (2) that the amount to be withheld will exceed the amount by which the individual's tax liability for the year exceeds the credits against such tax liability. Therefore, under the withholding proposal contained in H.R. 5867, unless such an individual who performs a service files a certification, the life insurance company will withhold 10 percent from the payment to that individual.

Individuals in many cases either will fail to file the required certification because of inadvertence or forgetfulness or will not file the certification in time for a payor to process it before making payment. In addition, payors will have to develop a system to receive and process the massive amounts of certifications that will be filed with them. The confusion and misunderstanding this withholding proposal will generate will be substantial.

We recognize that there may be a noncompliance problem regarding payments to independent contractors. However, we believe the solution to the problem contained in H.R. 5867 is too comprehensive, unnecessarily burdensome and complex and expensive. We believe that a strengthened information reporting system as contained in all the bills before you will, in most situations solve the problem. However, if the decision should be made to adopt a withholding requirement in this area, we recommend that any withholding be limited only to those groups where a serious noncompliance problem has been demonstrated.

CONCLUSION

In conclusion, we reiterate our support for the adoption of objective standards in the Internal Revenue Code for determining the employment tax status of individuals and urge that the Subcommittee favorably report a bill to the full Ways and Means Committee as quickly as possible. Further, we recommend that a withholding proposal not be part of any bill that is developed.

We appreciate having the opportunity to present our views on the issue of classifying workers for employment tax purposes. We would be happy to attempt to furnish any additional information the Subcommittee might think helpful.

STATEMENT OF THE AMERICAN HORSE COUNCIL

Mr. Chairman, the American Horse Council appreciates this opportunity to submit testimony on the legislative proposals relating to the classification of workers for Federal employment tax purposes. The bills would define and clarify the status of independent contractors for purposes of federal income, employment and social security tax withholding.

In essence, these bills (H.R. 4531, H.R. 5867, H.R. 6311, H.R. 4971, and H.R. 5729) would establish statutory "safe harbor" tests which, if met, would guarantee that a worker would be classified as an independent contractor. If not met, the common law rules would be retained for determining the employment tax status of workers. Several of the bills will also strengthen the information reporting requirements on employers and increase penalties.

The American Horse Council is a national association, consisting of over 140 equine organizations that represent over three million individual horsemen and women. A significant number of the people working in the horse industry have been treated as independent contractors because of the nature of their activities and the business. The AHC and its members are very concerned over recent IRS actions to reclassify independent contractors as employees.

Under common law, a worker is considered an employee rather than an independent contractor when the person for whom the services are performed has the right to control and direct the individual not only as to the result to be accomplished, but also as to the details and the means by which it is to be accomplished. There are approximately twenty factors to be considered in determining whether sufficient control exists to find that a worker is an employee. Reasonable men can differ on the outcome of the tests and these bills attempt to bring some certainty to the area.

All the bills would establish a five-part safe harbor test. These requirements relate to: 1) control of hours worked; 2) place of business; 3) investment or income fluctuation; 4) written contract and notice of tax responsibilities; and 5) the filing of required returns. If all the tests are met, an individual would be treated as an independent contractor. H.R. 4971 provides for three alternative tests, including the five-part tests just mentioned. If the requirements of any one of the tests are met a worker would be deemed an independent contractor.

The first requirement—control of hours worked—would be met if the worker controls both the aggregate number of hours worked and most of the scheduling. The bills take into consideration, and disregard, any limitations on scheduling that result from government regulatory requirements, operating procedures and specifications placed upon the person for whom services are performed, coordination of the service with the performance of other services, or the control of access to the premises by the service-recipient so long as the individual controls the scheduling of hours once access is granted.

The second requirement—place of business—would be met if the worker has no principal place of business provided by the service-recipient.

The third requirement—investment or income fluctuation—could be met two ways. First, the investment or income fluctuation test would be met if the worker has a substantial investment in tangible assets which he uses in connection with the service. Alternatively, this requirement could be met if the worker risks income fluctuations because more than 90 percent of his income is directly related to sales or output rather than number of hours worked.

The fourth requirement—written notice—would be met if the individual performed services pursuant to a written contract which expressly provides that he is not treated as an employee and gives him notice of his tax responsibilities.

Finally, the service recipient must file all the required information returns regarding payments made to the worker.

H.R. 4971 establishes three alternative tests for determining the status of an individual. Under this bill, an individual would be deemed an independent contractor if all the requirements of any one test were met. The first test is the five requirements listed above as the "safe harbor" tests. The second test requires that the individual: (1) Have a substantial investment in the assets used in the business; (2) own or hold the assets under a lease; (3) be responsible for maintaining the assets; (4) bear the principal burden of the operating costs while performing the service (5) be responsible for supplying the personal services necessary; and (6) perform the services pursuant to a written or oral contract. The third test would be met if an individual performed similar services for five or more payors during the preceding calendar years or is reasonably expected to perform services for five or more payors during the present taxable year.

The horse industry is a substantialy industry. In the last twenty years there has been tremendous expansion in horse sports, particularly in racing, showing and rodeos. Twenty-thousand horse shows a year provide entertainment for more than five million fans. The racing industry in 1981 handled over $12 billion in wagers in 29 states and generated a source of income for 175,000 people. It also provided another 125,000 jobs in subsidiary industries, such as breeding farms, feed suppliers, manufacturers and service industries.

Workers in the various segments of the horse industry are difficult to characterize. The nature of racing and showing is such that many of the key people involved in putting on the activity do not work year-round for a single employer. Many horse shows run only a few days and then participants move to another location for the next show. Similarly, many race tracks operate only a few months during the year and the admissions crews, mutuel managers, racing officials, jockeys, etc. move to another track. In most cases, these people are responsibile for their own activities, even though there are some practical constraints on their operation.

Horse show personnel may work at thirty or more shows in a year and racing officials may serve at four or five different tracks each year. Despite the itinerant nature of their work, however, these people are highly skilled. They are generally treated as independent contractors and various employers bid for their services. In many cases, they move in whole crews, set up, and operate the venture involved. Any decision by the IRS to reclassify these people as employees rather than independent contractors would create serious problems for the industry and disrupt their traditional ways of operating. The American Horse Council opposes any effort by the IRS to change long-standing industry standards.

The bills create in the law a "safe harbor" test. There will be no question that those who meet all five tests will be independent contractors and that income, unemployment, and social security taxes would not have to be withheld from amounts paid to them for their work. This brings a degree of certainty to the law which is now lacking.

At the same time, the bills provide that a service provider who does not meet one or more of the tests would not automatically be considered an employee. Rather, the determination of the status of these workers would be made by common law rules, as if the safe harbor tests had not been enacted. Thus, while providing the specificity necessary to add certainty to the law, the bill also retains a degree of flexibility which ensures that an equitable decision can be reached in many cases by considering the specific facts and circumstances of a worker's particular situation.

While supporting the intent of all the bills, we believe the tests in H.R. 4971 more accurately reflect the practical problems persons in the horse industry face. Such additional safeguards may be needed for those working in industries such as ours where unusual conditions prevail. With respect to the other bills, it is not clear whether the occupations discussed earlier would fall within the "safe harbors" created. The tests set forth in H.R. 4971 are more suitable for the unusual nature of the horse industry. The fact that these are occupations in which a skilled person works in a variety of locations during a given year for different clients in an unusual situation. In addition, many of the occupations are seasonal in nature. The independent contractor has considerable control over which offers he will accept and the periods when he will work, and also has the opportunity to independently negotiate his compensation and working conditions.

* * * * *

STATE LAW

Several bills—H.R. 5729, H.R. 5867, and H.R. 6311—provide that qualifications as an independent contractor under the safe harbor tests would not create any inference with respect to a person's status under provisions of law other than the Federal employment tax provisions. A number of states have statutes that classify workers at race tracks—jockeys, for example—as either independent contractors or employees for purposes of state laws. The AHC feels that a Federal statute, which deals with Federal employment tax provisions, should not affect state statutes and classifications. Each state should continue to be able to classify workers operating within its boundaries according to what it considers to be the public purpose. If this is the bills's intent, this relationship to state law should be clarified.

WITHHOLDING ON INDEPENDENT CONTRACTORS

H.R. 4531 and H.R. 5867 contain a provision that would extend Federal income tax withholding to monies paid traveling or city salesmen. While not affected by this provision, the AHC opposes in principle any withholding requirements on independent contractors.

We repeat our support for a workable, legislative solution to this problem. We urge the Subcommittee to note and resolve the special problems faced by those who work in the industries of an unusual nature, such as the horse industry.

STATEMENT OF BRENDA R. VIEHE-NAESS, TAX COUNSEL, AMERICAN INSURANCE ASSOCIATION

SUMMARY

The Association supports the enactment of the Independent Contractor Classification Act, but asks that the provision requiring information reporting of payments to independent contractors be modified: (1) The effective date for reporting requirements should be changed to January 1, 1984 to allow companies time to develop necessary computer systems; and (2) The exception for payments to⅛ corporations should be made part of the statutory language.

STATEMENT

I am Brenda R. Viehe-Naess, Tax Counsel of the American Insurance Association, a trade association representing 168 property-casualty insurance companies which wrote $32.2 billion premiums in 1980, or approximately one-third of the property-casualty insurance premiums in the United States.

The Association supports the enactment of H.R. 6311, the Independent Contractor Classification Act, as a much needed resolution of a long-standing dispute between the IRS and corporations. We believe that the reporting requirements of Section 3 of the bill are less onerous than mandatory withholding, which was proposed in prior years.

Surveys of our member companies have shown that two, quite limited revisions are necessary to make the reporting provisions workable.

First, the effective date for information reporting should be changed so that it will not apply to payments made after December 31, 1982, as proposed. Because of the uncertainties surrounding the passage of this legislation and other taxpayer compliance measures as well, corporations may face extensive new requirements for information reporting. If legislation were not enacted until July or August, or perhaps even the early fall, it would be difficult for companies to develop the necessary computer programs and to collect necessary Taxpayer Identification Numbers (TIN) by year-end. Demands on computer systems and personnel are heavy in the last quarter of the year, and developing new programs during that period presents an additional hardship. If the limitations of time and personnel prevent the systems from being operational by year-end, however, companies will face an awkward and difficult problem—payments will be made to agents, claims adjusters, and independent accounting firms and actuarial firms, which must be later entered into the information reporting system.

Insurance companies face a special problem in reporting the payments of agents' commissions. Many companies now provide for premium payments to their agents, who, in turn, transmit premiums net of commisssion. While companies ordinarily have data now on agents' commissions paid when it bills the policyholder directly, they need adequate time for programing to have this information printed in a format suitable for information reporting. Where premiums are remitted net of commissions, however, they do not have data now. Insurance companies must also resolve troubling accounting issues before reporting commissions for premiums remitted. In many companies, records for agent-billed business are kept on a written premium basis rather than paid premium basis. Information reports for payments to individuals should reflect actual payments more accurately than present systems would permit.

Second, we ask that an exception to the reporting requirements for payments to corporations be made part of the statute.

In his introductory statement to the companion bill in the Senate, S. 2369, Senator Dole recognized that it may be desirable to exclude payments to corporations from the reporting requirement: "Under the bill, these penalties technically apply only to information reports for payments by persons in a trade or business to other 'persons' as compensation for services. This statutory reference to 'persons' receiving compensation for services tracks the statutory language of current law which requires reports on payments to all 'persons,' a term which technically includes corporations. The Treasury, of course, will have regulatory authority to limit application of these rules to payments to individuals if it determines that reports of payments to corporations are unnecessary." (Congressional Record, April 14, 1982, p. S. 3509.)

We believe that the difficulties attendant upon reporting payments to corportations are so great and the need for such reporting is so much less that this requirement ought to be made part of the statute. As I explained above, companies do not now have this information, and where premiums are remitted net of commissions, they face severe problems in developing the necessary systems. In addition, incorporated agencies may operate on a cash basis while insurance companies operate on an accrual basis so that differences in their systems of accounting may limit the usefulness of information returns. However, unless the IRS were prepared to issue an emergency or temporary regulation, exempting payments to corporation, insurance companies and others would be required to race to develop the systems to capture this data, and then to abandon them within one or two years. We believe that compliance problems in payments to corporations are so much less that the Treasury will ultimately adopt an exclusion, as Senator Dole has suggested in his statement. We ask that the companies be spared the cost and time of developing systems to comply with these reporting requirements for any brief period after enactment of the legislation.

STATMENT OF THE AMERICAN NEWSPAPER PUBLISHERS ASSOCIATION

The American Newspaper Publishers Association is pleased to submit its views on H.R. 6311 designed to clarify the tax status of independent contractors.

ANPA is a non-profit trade association whose more than 1,400 newspapers represent more than 90 percent of the daily and Sunday newspaper circulation in the United States. Several nondaily newspapers also are members. ANPA is joined in this statement by the National Newspaper Association and the Internatinal Circulation Managers' Association. NNA represents some 500 smaller city daily and 5,000 weekly newspapers throughout the United States and its territories. ICMA is an association of some 1,350 newspaper circulation executives, mostly in the U.S.

Historically, newspapers as principals have engaged the services of independent contractors for performance of both editorial and commercial functions. There is no study known to ANPA which would pinpoint the number of independent contractors providing services to newspapers, but it is a matter of general knowledge in the newspaper business that publishers have traditionally used siginificant numbers of contractors for important tasks such as distribution to readers and newsgathering in reomote or sparsely populated areas. Independent circulation distributors undoubtedly number in the thousands.[1] Freelance correspondents are still a universal feature at both daily and nondaily publications. Other newspaper contractors include regional and rural delivery agents and independent advertising solicitors. These newspaper workers are proud of their status as independent buisnessmen and seek to maintain the benefits enjoyed by individual entrepreneurs under the American free enterprise system.

ANPA member publishers are vitally concerned that existing tax treatment of traditional contract arrangements be left undisturbed. As in the case of other employers, a newspaper may be secondarily liable for taxes owed by individuals whom the Internal Revenue Service administratively determines to be employees. This may occur in spite of management's good faith belief that the individual concerned is being dealt with on the basis of a contract arrangement and even in spite of express agreements over tax responsibility.

ANPA also believes that provisions of the Internal Revenue Code describing the line of demarcation between employees and independent contractors should contain adequate safeguards against arbitrary findings of employment relationships by federal tax authorities. Where potential past liabilities arising from adverse determinations of coverage may total thousands of dollars, fundamental fairness requires that a taxpaying principal have meaningful guidelines that will enable him to ascertain whether a contract for personal services will give rise to a duty to withhold wages for the contractor's future tax obligations.

---

[1] With respect to independent newspaper distributors, our comments relate to persons who are age eighteen and older, and those who are *not* engaged in sale and delivery of the newspapers to the reader under a wholesale-retail arrangement. The services of individuals selling and delivering to readers under a wholesale-retail arrangement is already removed from the operation of the federal tax laws by virtue of specific provisions in the Internal Revenue Code, regardless of the legal relationship between newspaper and distributor: 26 USC 3401(a)(10) (A&B)—Withholding; 26 USC 3306(c)(15) (A&B)—FUTA; 26 USC 3121(b)(14) (A&B)—FICA.

ANPA believes that in its overall concept H.R. 6311 would be an important and commendable addition to existing tax laws, and would help preserve existing tax treatment of traditional newspaper independent contractor arrangements. However, several specific provisions of the bill would be onerous for both newspapers and their contractors and should be amended before being submitted for Congressional consideration.

THE "SAFE HARBOR" TEST

The four part "safe-harbor" test contained in proposed section 3508 subsection (b) of the Internal Revenue Code of 1954 combines the essential elements of common law tests for independent contractor status and would permit an orderly evaluation of the tax-law status of particular arrangements made with individual workers.

Except as noted below, compliance with the various parts of the test would likely not place an unconscionable burden on taxpaying principals, although ANPA believes that traditional newspaper independent contractor arrangements are well within the purview of either the common law or the proposed statutory analysis, or both.

The first element of the test focuses on control of working hours by the independent contractor rather than the principal—reflecting the general view that an independent businessman arranges his or her own schedule for meeting the demands of the contract. That is the situation with newspaper contractors in traditional arrangements. For example, a newspaper distributor in usual circumstances carries out all the work of distribution and related activities such as billing and newscarrier training completely free from time constraints by the publisher, save for a general mandate that the newspaper be delivered to the reader as soon as possible after publication.

The second part of the test in proposed section 3508 requires that if an independent contractor has a principal place of business that it be furnished by the contractor and not the employee. In the newspaper business, contractors work from their homes and rarely have occasion to visit the newspaper plant for an length of time.

The third element of the "safe harbor" test—alternative requirement of investment in substantial assets or income fluctuation—is unsatisfactory in a number of respects, at least as currently drafted.

Concerning income fluctuation, the bill provides that a contractor must risk income fluctuation due to 90 percent of remuneration being directly related to sales or other output. While all newspaper contractors' income is directly related to output, the bill poses the possibility that the Internal Revenue Service may require the contractor or the service recipient to demonstrate that he or she actually faced the risk of loss of income as well as the possibility of making a profit.

In some instances this might be impossible for a newspaper independent contractor to demonstrate. For example, an independent newspaper distributor might be servicing a newly developed neighborhood, and would face only the prospect of an increasing number of subscribers and consequent increases in income. Thus while the distributor's income is related to output in the sense that increased work will result in greater numbers of subscribers, the newspaper or distributor might not be able to demonstrate that he or she risked loss of income.

The apparent, and understandable, intent of this provision in H.R. 6311 is to deny "safe-harbor" status to persons who are merely "salaried" by the service recipient. But it seems to be aimed at workers who are, for example, selling consumer merchandise in the home, and does not adequately provide for "safe-harbor" status for other legitimate independent contractor arrangements.

The provision in the subsection relating to investment in assets is also deficient when viewed from the newspaper perspective. It states that the investment in assets must be, "a substantial economic investment in light of the nature and amount of the remuneration received for the service . . ." This wording is somewhat vague, but the clear suggestion is that a contractor's tangible assets expense must be a significant percentage of income.

This does not reflect the economic realities of some newspaper independent contractor arrangements. For example, in the case of a freelance writer, what is being contracted for is the individual's journalistic skills and time spent in coverage of a story. A freelancer is unlikely to have any appreciable investment in assets beyond a typewriter, library or photographic equipment. A newspaper distributor has an investment in delivery supplies, but it cannot be known whether the investment would be "substantial" within the meaning of H.R. 6311, since the term is nowhere defined. Again, it would appear that the legislation in this respect might deny "safe-harbor" treatment to perfectly legitimate contractual arrangements involving newspapers.

The assets test also purports to exclude as a qualified asset, "any vehicle which is used primarily to transport the individual (and any tools, samples or similar items) . . ." In his remarks accompanying the introduction of H.R. 6311's companion bill, now before the Senate Finance Committee, Senator Dole, the sponsor, stated clearly that, "A vehicle used primarily for performing services, however, is not excluded under this rule." Nevertheless, this appears to be at variance with the express wording of the proposed statute.

It would be important for newspapers to obtain clarification of this aspect of the "safe-harbor" rule, since a vehicle may be the principal—and perhaps most important—asset of some newspaper independent contractors. Many freelance journalists are heavily dependent on their automobiles for transportation to and from news events that are to be covered and to deliver stories and photos to the newspaper. The same would apply to independent advertising solicitors who must visit potential clients over a widespread geographic area. To deny "safe-harbor" status to these contractual arrangements because of the use made of a necessary vehicle does not comport with the intent of the legislation to insulate such arrangements from unwarranted attack by the Internal Revenue Service.

The fourth requirement of the "safe-harbor" section is for a written contract and corresponding notification of tax responsibilities. The specific provision resembles the form of contract and notice used in the newspaper business, and probably other businesses, for longer term contractual relations. But, it seems insufficiently flexible to deal with contractual arrangements of short duration entered into on a one-time or very sporadic basis. The purpose of the fourth requirement is, of course, to insure that a worker is alerted to the fact that he or she is not an employee, and will have to assume responsibility for tax matters.

This purpose, we believe could be served in the circumstances described by permitting the contract and notice requirement to be satisfied by an executed oral agreement with notice evidenced by a writing. To illustrate, a newspaper might on occasion engage the services of a freelance journalist in a distant city to cover a single news event. The freelance will generally be told that payment is on a fee basis, and it is agreed that he or she must be responsible for payment of federal and state taxes. When subsequent payment is made to the contractor, usually after completion of coverage, there will generally be no indication of withholding for any purpose, and payment will generally be accompanied by notice of tax responsibility. This sort of arrangement should not be denied "safe-harbor" status due to absence of a prior written agreement. The goal of notifying the worker of non-employee status and tax responsbility will have been met as a practical matter, and for very occasional services there is no danger that large tax liabilities will accrue. H.R. 6311 can and should be amended to allow "safe-harbor" treatment for sporadic contractual relationships, perhaps with a limitation on the number of times that any procedure could be used within a particular tax year.

REPORTING AND PENALTY PROVISIONS

As a substitute for previous Internal Revenue Service proposals that service recipients withhold a percentage of payments to a contractor, proposed Section 6041A imposes enhanced reporting duties for such payments. It may be argued that reporting requirements are preferable to withholding, but this proposed Section nevertheless constitutes additional government paperwork duties and regulation.

The majority of newspapers are small businesses, and it is well known that small business in general is already laboring under an intolerable burden of government-imposed recordkeeping and paperwork. Therefore, ANPA vigorously opposes any addition to present requirements. This is especially true in light of the fact that existing Code Section 6041 already provides a framework for reporting payments to a contractor.

H.R. 6311 contains proposed Internal Revenue Code Section 6660 which specifies penalities for failure to file the returns called for in proposed Code Section 6041A. Although it is acknowledged that the Internal Revenue Service should have some mechanism for insuring reporting of payments to contractors, for compliance purposes, ANPA must note its opposition to the punitive approach embodied in the proposed Section.

On its face H.R. 6311 is very complex and technical tap legislation which will undoubtedly generate rulemaking on the part of the Internal Revenue Service. If passed, the law will require thorough analysis by attorneys, accountants and others who must advise their business clients using contractors about the scope of their duties, if any.

As with other small businesses, there may be a prolonged delay before some newspaper become aware of the new law, much less be able to get a determination concerning its effect on any existing contractor arrangements. Some may not become aware of the new law at all, and, as with any novel legislation of this type, there will certainly be initial uncertainties about the extent of its application.

There should be no penalities at all imposed on a first time failure to file retuns in a given tax year. It is unconsicionable to levy heavy monetary sanctions against small business in connection with a new tax law. Moreover, the purpose of compliance provisions of the type contained in H.R. 6311 shold be to insure compliance—not to punish businesses for failure to fulfill requirements whose exact parameters may be unclear. The bill shold be amended accordingly or the penalty provisions deleted.

In conclusion, ANPA supports the concept of continued protection for traditional contractor arrangements embodied in H.R. 6311 Congress acted wisely in affording temporary "safe-harbor" status to independent contractor arrangements in the interim relief provisions of the Revenue Act of 1978, effectively prohibiting reclassification efforts by the Internal Revenue Service. We are in general agreement with the concept of H.R. 6311 because this legislation perpetutates that wisdom. The bill is in keeping with the spirit of American free enterprise, and it contains guidance by which all parties—the Internal Revenue Service, service recipients and workers—can be confident about their tax responsibilities.

STATEMENT OF THE AMERICAN PETROLEUM INSTITUTE

This statement is submitted on behalf of the American Petroleum Institute. The API welcomes the initiative evidenced in legislation concerned with the proper tax treatment of either employer/employee or principal/independent contractor relationships with respect to payroll taxation and income tax withholding. The Bill introduced seeks to relieve the chaotic situation which currently exists in regard to this issue. However, because of the short period between the time H.R. 6311 was introduced and the time the moratorium on action by the Internal Revenue Service will expire, and in light of additional issues presented in the bill, the moratorium should first be extended to allow for careful analysis of the new provisions. Specifically, the withholding requirements relating to certain payments to independent contractors and the penalty provisions should not be approved.

INTERNAL REVENUE SERVICE ACTIVITIES GIVING RISE TO THE NEED FOR LEGISLATION

In a departure from existing case law and rulings, the Internal Revenue Service has taken actions which impose severe hardships on many businesses and individuals by dramatically altering the application of the withholding provisions of the Internal Revenue Code and of the requirements of the Federal Insurance Contribution Act (FICA) and the Federal Unemployment Tax Act (FUTA).

Specifically, the Service has sought to reclassify as "employees" many persons who traditionally have been treated as independent contractors. The problem has been further exacerbated by the retroactive imposition of taxes and penalties as a result of such reclassification.

The 96th Congress passed H.R. 6975 (Public Law 96-541), which extended through June 30, 1982, a ban on the Internal Revenue Service issuing regulations which would have the effect of reclassifying independent contractors as employees; thus, allowing the 97th Congress sufficient time to enact dispositive legislation which will provide proper guidance for the determination of employer/employee status under the Internal Revenue Code.

ADDITIONAL CONSIDERATIONS POINTING TO THE NEED FOR PROMPT ACTION BY THE CONGRESS

If Congress does not legislate an equitable resolution to this problem or fails to extend the moratorium the continuation of the past practices of the IRS will adversely affect the business community in the following ways: (1) Many businesses will become subject to additional FICA and FUTA taxes and will also be subject to the withholding requirements for Federal income taxes and the employee's share of Social Security taxes.

(2) The retroactive imposition of taxes and penalties as a result of reclassification will, in some cases, result in the duplicate payment of these taxes thus jeopardizing

the solvency of many small businesses. Frequently, the taxes imposed upon the employer as a result of reclassification have already been paid by the newly designated employee in his previous status as an independent contractor. This problem is aggravated by the policy of the IRS not to search its records to ascertain whether or not the claimed withholding taxes have already been paid by the person who has been reclassified.

(3) The IRS reclassification of a large number of independent contractors as employees could have substantial impacts on both company-sponsored retirement benefit plans and the Keogh Plans or Individual Retirement Accounts of the reclassified individuals. Under current laws, some of these impacts are as follows: (a) The tax-qualified retirement plan of the employer could be disqualified; (b) In order to prevent disqualification of the employer's plans, the reclassified individuals would have to be brought into them retroactively. This would create many actuarial and benefit determination problems, together with large funding deficits; and (c) In case of either (a) or (b), these reclassified individuals who had been taking deductions for contribuition to Keogh Plans or Individual Retirement Accounts could have these plans disqualified. Their deductions could be recaptured with tax, interest, and penalties assessed. In some cases, the terms of these individual plans would remain in force, preventing the individuals from drawing on these funds to meet the assessments. The financial effect on such an individual would be devastating.

For the foregoing reasons, it is imperative that this Congress act promptly to resolve this most important issue.

PROPOSALS OF THE GENERAL ACCOUNTING OFFICE (GAO)

In its Report Number GGD-77-88, the GAO accurately described the chaotic situation existing in regard to classification of the individual worker. To remedy this, the GAO report proposed several recommendations which would alleviate some of the uncertainties and inequities arising in the application in this section of the Code. However, these recommendations conclusively classified an individual as an employee if at least three of its requirements were not met. They failed to permit the application of the common law test in all situations outside the "safe harbor" definition prescribed for the independent contractor. H.R. 6311 makes the common law test automatically applicable when the facts do not precisely fit the "safe harbor". The GAO, in a statement by Daniel F. Stanton, Deputy Director, before the U.S. Senate Committee on Finance, Subcommittee on Oversight of the IRS, supported the two tier test of S. 2369, the Senate counterpart to H.R. 6311. It is for this reason that we strongly favor the enactment of H.R. 6311 subject, however, to a few very important modifications.

The common law test has been an intergral part of the law since the founding of the United States. It is relied on to establish many aspects of business and legal relations between people, including the relationship for determining liability for Federal employment taxes. Other examples include: coverage in and qualification of employee retirement plans and other benefit plans, the validity of Keogh plans, liability under tort law, and Government regulations on allocation and price controls of petroleum products. There is occasionally some difficulty in applying the test in marginal situations. However, the test is superior overall to the alternatives that have been suggested, and any change in the law would breed new areas of uncertainty and confusion. The common law test has withstood the test of time and should be retained.

The essence of the common law test is control. An employment relationship exists if the employer has the right to control not only the end product of the work but the moment-by-moment details of how the work will be performed. Independent businessmen are obviously not subject to such detailed control; they are motivated instead by individual initiative. If Congress permitted the law to be changed so that independent business men would be treated as employees for employment tax purposes, it can be expected they will eventually be treated as employees for other purposes, thus eliminating many independent businessmen and individual initiative. This could have profound effect on the American economic system.

It is a fact that substantial problems have arisen in the administration of the employment tax laws. The problems are not inherent in the common law test. They result from efforts by the IRS to expand the definition of "employee" to cover independent businessmen, and the absence of adequate procedural and judicial remedies to protect taxpayers.

H.R. 6311—A GOOD BEGINNING

We support the basic thrust of H.R. 6311, and commend its sponsors for their efforts to bring clarification to what has been a very confusing area of our tax law.

H.R. 6311 would establish a five-part "safe harbor" test which, if met in full, would result in an individual being classified as an independent contractor rather than an employee. To qualify as an independent contractor under the "safe harbor" test, a person must meet all of the following requirements: (1) The person must substantially control his own work hours and work schedule.

(2) The person does not maintain a principal place of business or, if he does so, such main place of business is not provided by the person for whom he performs services, or the person pays a fair rent if such place of business is so provided.

(3) The person has a substantial investment in his own business or the person risks income fluctuations because his remuneration with respect to services is directly related to sales or other output rather than to number of hours worked.

(4) The service is performed pursuant to a written contract which: (a) was enterd into before the performance of the service; (b) provides that the person will not be treated as an employee for purposes of the Federal Insurance Contributions Act, the Federal Unemployment Tax Act, and income tax withholding at source; and (c) the person is provided written notice of his responsibility with respect to the payment of self-employment and Federal income taxes.

This requirement will be deemed to be satisfied with respect to contracts entered into before January 1, 1983, if such contracts clearly indicate that the individual is not an employee (either by specifying that the individual is an independent contractor or otherwise) provided that such notice is given before January 1, 1983.

(5) The person for whom the worker performed services must file information returns (Forms 1099).

If the five factor "safe harbor" test is not met, the worker may still be classified as an independent contractor if he can meet the requirements of a "common law" test. As noted previously, this test focuses on the control exercised over the worker whose status is at issue. For example, a worker will not be treated as an employee unless the person for whom he performs services controls or has the right to control not only the result to be accomplished but also how that result is to be accomplished.

We submit that the approach taken by H.R. 6311 is the correct approach. It is in keeping with the recent statement of the Supreme Court in the case of *Central Illinois Public Service Company* v. *U.S.*, 98 S. Ct. 917 (1968), wherein the Court said: "Because the employer is in a secondary position as to liability for any tax of the employee, it is a matter of obvious concern that, absent further specific Congressional action, the employer's obligation to withhold be precise and not speculative."

The enactment of H.R. 6311 with modifications will provide precision and remove speculation with respect to the tax treatment of individuals who may be argued to be either employees or independent contractors under current provisions of the Internal Revenue Code.

SUGGESTED AMENDMENTS TO H.R. 6311

There are several situations and conditions not covered by H.R. 6311 which we believe should be addressed. The situations to which we would like to invite your attention are discussed below.

Of primary concern is the introduction of the additional penalties with respect to returns required under Section 6041A. This requirement is not necessary. First, the general penalty provisions applicable to all 1099 Forms already provide adequate penalties. Second, there is no need to clutter the definitional purpose of the bill, with these complicated penalty provisions. Finally, for the sake of administrative simplicity, all Form 1099s should have the same penalty provisions applicable as provided in Section 6652 of the Internal Revenue Code.

Considering that proposed new Code Section 6041A applies only to service recipients engaged in a trade or business and that such entities are already subject to the reporting requirements of Section 6041 and the penalty provisions applicable thereto, it does not seem reasonable—merely because service is involved—to impose new or different penalties than would be applicable to a failure to comply with existing Section 6041.

The penalty of Proposed Section 6660(a)(2) and the special penalty (surcharge) of Proposed 6660(b) have all the marks of unfairness when compared with the penalties applicable to Section 6041. For example, the penalty which Section 6652 imposes for failure to comply with Section 6041A is $10 for each failure, with a maximum penalty of $25,000 for any one calendar year. Under Proposed Section 6660(a)(2), the penalty is 1 percent for each month the failure continues (but not in excess of 5 percent), multiplied by the amount required to be included in the return which was not included in the return. Under these provisions, the monetary penalty could be astronomical for making errors on just a few returns. If, say, only five returns of $100,000 each are missed, the penalty for these five could be as high as $25,000, and there is no limit. This should be removed.

Moreover, the very working of the surcharge could be highly discriminatory, as between taxpayers, because of its percentage basis. A taxpayer with a small number of information returns to be filed, each of which represented large amounts, and who erred (without establishing reasonable cause) on only a few such returns, but which represented a large percentage error, would be subject to a very large monetary penalty; whereas a taxpayer with a large number of returns to be filed, but with an error factor of 10 percent or less, would incur no surcharge. In general, we feel that the penalty provisions of H.R. 6311 are much too harsh and too complex.

API believes that under no circumstances should a payor be required to withhold amounts on payments to independent contractors. If a qualified payee fails to provide a required indentification number or provides an incorrect one, he, and he alone, should bear the consequences of his action. The payor should not, because of the payee's inadvertence, be put to the administrative effort of having to withhold from his remittance (with all the accompanying accounting problems, deposits, and reporting to IRS). At most, the payor should be expected to report the payee's failure to IRS for its follow-up in a manner similar to an employer's obligation to report invalid W-4 forms received from employees. Withholding from a remittance to a payee, with all its accompanying consequences, is not a small chore for the payor. If there is to be any special burden to be borne, it should rest where it belongs—on the payee. In the case where an independent contractor supplies an erroneous identification number, it is clearly unfair to impose the withholding responsibility on the payor. How is he to know the number is incorrect? By the time the erroneous number is disclosed, the independent contractor could be no where to be seen. A payor should not become liable for the payee's taxes when the payee provided the erroneous information.

Irrespective of whether the safe harbor or common law tests are met the IRS should be prohibited from disqualifying retroactively the qualified pension, profit-sharing and employee stock ownership plans of the business or the reclassified individual as a result of a reclassification of non-employees as employees, where they have in good faith treated the individuals as non-employees for purposes of withholding taxes and participation in such plans. Retroactive application should only occur when fraud or bad faith has been practiced. Such retroactive disqualification does not serve the just administration of the tax laws, the private pension system, or most importantly the participants of the plans, whose rights are sought to be protected by the pension reform laws. The need to avoid retroactive disqualification of private plans takes on added significance when one considers the problems the Social Security System is facing today.

It would be helpful if the requirement of meeting all of the five criteria of independent contractor status be changed to four-out-of-five, in order to provide greater flexibility in qualifying under the safe harbor rules. One difficulty has always been the subjectivity involved in determining the type relationship which exists. Different individuals have different views of the facts. One possible alternative would be to have payee submit a statement certifying that the three subjective tests are met. Even the five criteria for a safe harbor, although a significant improvement, will leave considerable room for differences of opioion. Thus, having to meet only four of the five criteria will make it easier for divergent opinions to be reconciled on the broader concept of a safe harbor rule. The five out of five requirement places a significant burden on the payor to determine such subjective elements as "significant" value of assets, "substantial" investment, "principal" place of business, "substantial" control of hours. It is too much to ask of an individual to determine beforehand that all five requirements are in fact met.

We feel that an objective of any legislation in this area should be to assure that in a marketing arrangement where an individual is basically running his own business of buying goods and selling them at self-determined prices, and rendering service in connection therewith, to the general public, the law clearly provides for the treatment of such person as an independent contractor without any further inquiry being necessary. Unless this clear-cut protection is provided in the law, it is believed that many situations will still exist where it is difficult for people engaged in selling operations to establish a safe harbor, thus, imposing upon them the burden of establishing their status under the traditional common law rules. Common sense requires that in a situation where no money is passing hands except for the goods purchased and there are no payments from which to withhold taxes, the situation must be regarded as that of independent contractor. We hope the efforts of this Subcommittee will provide this category of individuals and the people they deal with some relief from the constant threat of having their status challenged.

The fourth requirement of the safe harbor provision provides "the individual performs the service pursuant to a written contract between the individual and the service-recipient which was entered into before the performance of the service". There is no practical reason why the written contract must be entered into before the performance of services. The "before" language is only a trap for the unwary and should not be a mechanism for the Service to prevent an innocent individual from falling within the safe harbor rule. The purpose of the written contract requirement is to provide notice to the independent contractor, thus the time the written contract was entered into should be irrelevant. Alternatively, the requirement could be moderated to provide that the parties have 30 days to enter into a written contract.

New Proposed Section 6041A(b)(1) requires an information return to be filed on direct sales of $5,000 or more. In keeping with the intent of this provision, as expressed in the explanation, the provision should be limited only to sales to individuals who have insignificant investments in tangible assets which are needed in the performance of the resales in the home. In such a case personal cars owned by the direct buyer would be considered a personal asset rather than an investment, with samples, catalogs, and displays constituting insignificant investments. For example, see the limitation found in Proposed Section 3508(b)(3)(B)(i). By making this qualification, the new provision will continue to apply to direct sales to sale representatives while removing any possible ambiguity in interpretation of the statute.

In a situation in which an independent contractor has employees of his own, who render services to others, it is essential that any legislation enacted will prevent duplication of withholding for income tax purposes and for the employee's share of FICA taxes; and to preclude a dual tax burden in regard to employers' share of FICA and FUTA provisions. It should also provide for the designation of which the contracting parties is the individual's employer fo purposes of employee benefit plan coverage.

Frequently, it is necessary to establish, on a limited basis, a relationship with an outside consultant in order to gain the benefit of expert knowledge not otherwise available. Any legislation should assure that an individual will not be considered an employee in a situation where an outside consultant is engaged to perform a specific task on an ad hoc basis. Such individual would probably have difficulty in meeting other criteria of the proposed legislation. Therefore, we suggest that the third alternative requirement of proposed Code Section 3508(b) be expanded to include the situation where an individual would not be able to meet the investment of income fluctuation criteria but would be covered if the retention of service is limited in scope with regard to time or the nature of the services.

The retroactive reclassification of individuals as employees, and assessment of taxes against the alleged employers, should be barred where treatment has been in good faith upon a reasonable basis. Such reclassification should be allowed only where fraud has been practiced, and even in such a case, the IRS should be required to examine its own files with respect to the reclasified workers to determine the income and employment taxes already paid by such worker, which amount should be allowed as an offset against any assessment, as is the case under current law.

As Mr. Justice Brennan stated in his concurring opinion in the *Central Illinois* case, supra, there is no evidence of any "congressional intent to make employers guarantors of the tax liabilities of their employees, which would in all likelihood be the result if withholding taxes can be assess retroactively."

Neither, could it have been the intent of Congress in enacting the withholding statutes that income and employment taxes were to be collected twice on the same income.

The jurisdiction of the Tax Court should be extended to controversies where controversies relate to employee/independent contractor issues. This will bring the expertise of the Tax Court to such controversies, and will remove the necessity of reclassified employers to face bankruptcy by paying assessed taxes prior to litigating the controversy. H.R. 4531, introduced September 21, 1981, by Representative Conable, contained such a provision.

ADMINISTRATIVE PROPOSALS

In a statement to this Subcommittee, Assistant Secretary of Treasury Chapoton supported the retention of the common law and a safe harbor test. Under his view, however, the safe harbor would apply only if the individual is paid on other than an hourly or salaried basis and meets one of the following conditions: (1) The worker maintains a prinicpal place of business, including a part of the house qualifying under Section 280A, (2) has substantial assets used on connection with the performance of the services, or (3) incurs substantial unreimbursed expenses.

The problem with this type of safe harbor provision is that it over-emphasizes the importance of how payment is to be calculated. If payment is made on an hourly or salaried basis the safe harbor cannot apply. The distinction between employees and independent contractor revolves around the question of control versus independence. The issue of how payment is to be calculated has no relevance to either and should not be part of the safe harbor.

The Assistant Secretary also proposes an "anti-switching" rule which would prevent employers who have treated their workers as employees under current law from switching these workers to independent contractor status merely because insubstantial changes in the employment relationship could qualify under the safe harbor provision as proposed.

We see no reason why an employer, on a prospective basis cannot change the status of a relationship he has with a service provider. In fact, the concerns of the Assistant Secretary dealing with prospective problems of the safe harbor provision, vividly illustrate the concern of the API with respect to the retroactive application of a change in an individual's treatment as an employee rather than an independent contractor.

The Assistant Secretary has suggested that the information reporting threshold be reduced. While the API recognizes the IRS' need for information to insure compliance, this need must be balanced against the administrative burden placed on the payor and IRS' ability to use the information and enforcement if received. The present threshold levels provide such a balance. Decreasing the threshold only penalizes the payor. The payor is not the one who is failing to pay.

The Assistant Secretary urges that the penalty for failure to file an information return with respect to independent contractors be imposed without a statute of limitation. H.R. 6311 presently contains such a provision. API commends its inclusion and suggests that the limitation period should be reduced from six to three years so as to reduce the record keeping burden of the payors.

The Assistant Secretary stated that the penalty provisions are too complex. As we have already pointed out, one problem of the bill is the complex penalty provisions. Thus, we suggested that the penalty provisions be eliminated with penalties being determined by the general penalty provisions which apply to all 1099 Forms. Unfortunately, the Treasury has suggested an alternative complex penalty provision, based on a percentage of compensation not reported. The Assistant Secretary has contended that simplicity is served by this alternative. API disagrees. Simplicity in administration can only be served if the same penalty provisions apply to all 1099 Forms.

The Treasury agrees with H.R. 6311 that payors to independent contractors should withhold amounts when erroneous or no identification numbers are provided by the independent contractors. Once again the wrong party is penalized. How is the payor to know if an erroneous number is furnished? The law should penalize those who provide the wrong or no information.

The Treasury has argued that prepayment review in the Tax Court not be available. Its reason is the present heavy court load in the Tax Court and the fact that a taxpayer can have access to the Court of Claims or District Courts based upon payment of a small fraction of the amount at issue. Granted there is case law which upholds this position. However, there is no guarantee that the Service will not change its position on the subject or that other courts will not conclude otherwise. Thus, the Tax Court route to litigation is necessary to assure a fair tax system.

Finally, the Assistant Secretary stated his concern on the retroactive application of an individual's status as an employee when the employer had a reasonable basis to treat the worker as an independent contractor. Possible solutions were advanced. However, in the API's view if a reasonable basis existed to treat a worker as independent contractor, the only logical and fair solution would be not to have the rule applied retroactively.

STATEMENT OF ASSOCIATED BUILDERS & CONTRACTORS, INC.

The Associated Builders and Contractors (ABC) is a national construction industry trade association representing approximately 17,000 firms nationwide which are responsible for the employment of approximately one million employees. The members of ABC operate under the "merit shop" philosophy—a concept which calls for open competitive bidding with contracts awarded to the lowest responsible bidder. At present, more than 60 percent of all construction work in this country is performed through the "merit shop" method.

ABC appreciates this opportunity to submit our statement regarding the standards used in determining whether particular workers or classes of workers should be treated as employees or as self-employed independent contractors (employers) for purposes of employment taxes and other related purposes. We believe H.R. 6311 and other proposals currently before Congress are sincere efforts to improve tax compliance while maintaining the independent contractors status for income tax purposes.

As with much of the construction industry in the United States, our members are predominantly small businesses, many of whom are classified for tax purposes as independent contractors. The distinction between an individual classified as an individual contractor (i.e., self-employed) or as an employee is important because employees and their employers are subject to tax under the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUCA), whereas independent contractors are subject to tax on self-employment income (SECA). Also, income of employees is subject to income tax withholding, whereas income tax of independent contractors is paid on a quarterly basis on their own behalf. Further, self-employed persons are able to establish Keogh retirement plans, whereas employees are not (although they are able to establish Individual Retirement Accounts). As a result of these factors, the social security tax rate on an independent contractor is lower than the combined employer-employee tax rate. Also, independent contractors are not subject to federal unemployment taxes because they are ineligible for unemployment benefits.

The independent contractor is an important part of the American economy and is essential if individual entrepreneurship in small business is to flourish in the United States. These entrepreneurs in the construction industry are independent individuals who are willing to undertake the risks involved in operating their own business in return for the benefits of success. Some of these risks incurred in the unique nature of our business include differing site and soil conditions; climate conditions; firm prices for the duration of the contract which require the contractor to bind himself to an unalterable price before actual costs are known; owner retention policies; changes; modifications or claims during the course of the contract which require the contractor to expend large sums in advance of his contractual right to collect from the owner; and intense competition within the industry which forces profit margins to be exceedingly small in relations to the total gross contract amount; among many others. It is critical to our economy that there be maintained a competitive construction industry which performs construction services for the nation at the lowest possible costs. Maintaining the tax status of independent contractors, with the appropriate income reporting responsibility, is a significant element in providing a more accessible marketplace in which to compete.

Over the past several years, the Internal Revenue Service has begun a campaign to change the tax status of small business people from independent contractors (or employers) to employees. In addition to presumed increased revenue, one of the major reasons for this attempt by the IRS was to make its own administrative functions easier. This attempt, however, led to an effort toward making substantial legislative changes to ease these administrative functions.

The conclusion of enhanced revenues as a result of reclassification of independent contractors as employees is presumptive. Revenue is not greatly increased because an independent contractor pays, on his own behalf, income and social security taxes corresponding to those withheld and paid by an employer on behalf of his employees (unless some increase was recognized due to the difference between FICA and SECA taxes). Reclassification as an employee may even result in decreased revenue by costing the newly established independent contractor his business due to increased tax, bookkeeping, and other administrative costs to the "employer."

Clarification of tax status has become necessary only over the last few years, due simply to the misapplication of the long established common law test by the IRS. Given the nature of the construction industry and the unstable economic conditions under which we must conduct our business, ABC's position regarding a solution to the independent contractor issue is there recognition of a clear "safe harbor" for independent contrators who have substantial capital assets invested (including equipment owner/operators, the most significant group of independent contractors within the construction industry), and a general statutory recognition of the common law principles which have been used historically to classify independent contractors. These common law principles should be recognized by statute to eliminate the potential for reclassification of independent contrctors to employees. Drafting a single safe harbor to provide particular classification for all such independent contractors would be extremely difficult, if not impossible. Therefore, it is important not only to provide a clear safe harbor for those individuals covered but to recognize the common law as providing a sound basis for administering the continuation of this class of small business people. ABC maintains that increased tax compliance of all business people is a responsibility of citizenship. We do believe, however, that penalties must be structured to increase compliance and not be disguised as mere revenue collection vehicles.

Although the safe harbor provisions proposed in the Independent Contractor Tax Classification and Compliance Act of 1982 (H.R. 6311) generally provide a five part test where each element can be met, the difficulty of drafting such a multipart test can be seen as follows when applying it to the primary categories of independent contractors. Therefore, the principles outlined in common law provisions are an appropriate alternative to the safe harbor necessary for preserving this class of individuals.

1. Control of hours worked.—Regarding the control of the work function based on the control of hours worked, H.R. 6311 would provide a general solution to the independent contractor situations which are common in the construction industry. However, the parameters outlining the safe harbor would not always be applicable based on the uniform work function and organization. Common law principles are necessary as a result.

For example, in the construction industry specifically, a contractor often must schedule a variety of activities at the same time (i.e., dump trucks must be available at the time cranes are digging out soil). S. 2369 allows equipment operators to have their control limited due to operating procedures and specifications the service recipient is required to comply with by contract. While this rule would exempt equipment scheduling in most construction project situations, it would not apply to a project being performed by a general contractor who is also acting as a developer. In this situation there would be no contract to perform the work and, despite activities identical to that performed, if a contract existed the operators would not be eligible for safe harbor protection. This example again illustrates the difficulty of drafting a single rule and the necessity of a statutory recognition.

2. Place of business.—This requirement of the Act takes into account the fact that, under the common law test, an independent contractor must provide his own place of business, and this place of business must not be provided by the service recipient unless paid for by the independent contractor.

It is important that any legislation clarify that access to a job site and the temporary equipment storage or parking of related vehicles at the site not be construed as "providing a place of business." Since it is necessary that construction work be performed at a job site, it would place prohibitive expense on the owner/operators to move their equipment each night.

3. Investment on income fluctuation.—This two-part safe harbor test requires that an independent contractor be subject to the risks of income fluctuations. First, the investment in assets must be of significant value in the performance of the service and this investment must be substantial in comparison to the nature and amount of remuneration.

Alternatively, this test recognizes that the potential of income fluctuation, if over 90 percent of the remuneration, results directly from output rather than hours worked.

This test also provides a "special rule" that would exclude the value of vehicles used to transport the individual and/or tools. While ABC agrees that an income fluctuation test is an appropriate safe harbor requirement, we contest the exclusion of the value of vehicles used to transport owner/operators and/or tools to a job site. This exclusion may revent certain individuals (especially those just starting their business) from qualifying for safe harbor protection even though they have a substantial personal investment in these vehicles purchased for and used solely in connection with their business. And, as previously mentioned, due to the variety of independent contractor functions, the operator proficiency necessary to utilize certain tools makes them valuable even if the tools themselves are not "significant" in relation to remuneration. Therefore, in light of these factors, ABC suggests that a test providing a substantial asset requirement would be a valid test.

Regarding the alternative income fluctuation aspect (based on the form of compensation), 90 percent of the remuneration for service must be based on output in order for an independent contractor to qualify for safe harbor protection. Since industry billing practices are based on hourly compensation rates (even for specific projects such as the installation of plumbing or electrical wiring), this billing arrangement is used because it is impossible to estimate costs due to unforeseeable complications in the construction process. This practice can also reduce costs to an independent contractor if he is well organized. Therefore, this alternative requirement of the test would disallow eligibility of some job functions for safe harbor inclusion. Since the most significant category of independent contractors in the construction industry—equipment owner/operators—are generally covered within the safe harbor rules, this is another example of the need for recognition of common law principles.

4. Written contract.—While ABC acknowledges the advantages of requiring a written contract as a compliance mechanism, we must emphasize that in the construction industry independent contractors must frequently deal directly with job site managers. It should not be underestimated that it is difficult to collect information accurately from job sites. Since the paperwork costs to these individuals is significant, the practical difficulties involved in record keeping will most likely cause some firms to forego the written contract requirement, thus leading to the failure to comply with the safe harbor (even if the independent contractor would qualify under the substantive segments of the safe harbor rule).

With regard to filing penalties, ABC realizes that information filings are a tax compliance device. We restate our position that tax compliance is a duty of responsible citizenship. However, although tax compliance will undoubtedly improve as a result of increased penalties for noncompliance, these penalties should be based on factual information reflecting any inadequacies of current penalties. If these current information filing penalties (increased last August under the Economic Recovery Act of 1981) are inadequate, then reports of any substantive analysis undertaken by the Internal Revenue Service should pinpoint any inadequacies before increased penalties are assessed.

The most significant factor in preventing arbitrary reclassification attempts by the IRS is the recognition of traditional common law principles. Due to the difficulty of drafting a safe harbor covering the various functions traditionally performed by independent contractors in the construction industry, the common law is necessary (although the statutory safe harbor protecting equipment owner/operators is an equally essential element to a resolution of the independent contractor issue.)

ABC recommends that legislation affecting the safe harbor classification of independent contractors contain the current IRS definition of independent contractors to preclude any future expansion by IRS of the current common law test enlarging the "employee" definition and narrowing the independent contractor definition.

STATEMENT OF THE ASSOCIATED GENERAL CONTRACTORS OF AMERICA

The Associated General Contractors of America (AGC) represents more than 30,000 firms, including 8,500 of America's leading general contracting companies which are responsible for the employment of more than 3,500,000 employees. These member contractors perform more than 80 percent of America's contract construction of commercial buildings, highways, industrial and municipal-utility facilities. We appreciate this opportunity to submit written testimony regarding the standards used for determining when individuals are not employees for purposes of employment taxes and other related purposes.

AGC has testified on the issue of the tax classification of independent contractors in prior years. We are pleased to be able to support the approach to resolving this issue contained in H.R. 6311. We believe that H.R. 6311 is an effective approach to improving tax compliance while maintaining the independent contractor status for income tax purposes.

The construction industry in the United States is characterized by thousands of small businesses. The entrepeneurs involved in construction are independent people willing to assume the risks of business in exchange for the benefits of success. The relative ease of entering the construction industry is a critical element of maintaining a competitive indusry which performs construction services for the Nation at the lowest possible cost. Maintaining the tax status of independent contractors, with the appropriate income reporting responsibilitities, is a significant factor in preserving the competition within the industry.

AGC's prime interest regarding a solution to the independent contractor issue is the statutory recognition of a safe harbor which includes equipment owner/operators, the most significant group of independent contractors in the construction industry and a general statutory recongnition of the common law principles which have been used historically to classify independent contractors. There are numerous business functions in construction. Drafting a single safe harbor to provide certain classification for all such independent contractors would be extremely difficult if not impossible. Consequently, common law principles must be recognized by statute to eliminate the potential for reclassification of independent contractors to employees. While a safe harbor will provide protection for those individuals covered, only the common law can provide a sound basis for administering the continuation of this class of small business people.

SAFE HARBOR RULES

The safe harbor provisions in the bills currently pending in Congress generally provide a five-part test where each element must be met. The difficulty of drafting such a multi-part test can be seen in its application to the major categories of independent contractors as discussed below. The recognition of traditional common law principles as an alternative to the safe harbor is a necessity for preserving this class of individuals.

Control of hours worked.—The first of the five-part tests generally deals with the issue of controlling the work function. The test is based on the control of hours worked. H.R. 6311 would provide a general solution to the independent contractor situations which are common in construction. However there are instances when the safe harbor would not be applicable based on the identical work function and organization. As a result is necessary to recognize the common law principles by statute.

In construction, it is often necessary for a general contractor to schedule a variety of activities which must be performed at the same time. For example, dump trucks must be available at the time backhoes and cranes dig out soil. H.R. 6311 allows equipment operators to have their control limited due to operating procedures and specifications the service recipient is required to comply with by contract. While this rule would exempt equipment scheduling in most construction project situations it would not apply to a project being performed by a general contractor who is also acting as a developer. In this situation there would be no contract to perform the work and despite activities identical to that performed if a contract existed, the operators would not be eligible for safe harbor protection. This example again illustrates the difficulty of drafting a single rule and the necessity of a statutory recognition of the common law principles.

Place of business.—The second part of the five-part test requires that a place of business for performance of the service not be provided by the service recipient unless paid for by the independent contractor. We suggest that it be made clear that access to the job site and temporary parking or equipment storage facilities made available at the site not be construed as providing a place of business. It is a necessity that work be performed at a job site in construction and often it would be prohibitively expensive for equipment owner/operators to move their equipment each night.

Investment and income fluctuation.—The third safe harbor test requires that the independent contractor be subject to the risks of income fluctuations. The test is applied in two alternative parts. The first part requires that investments in assets are significant in value and that the investment in the assets be substantial when compared to the remuneration. The value of vehicles used to transport the individual and/or his tools is generally excluded. The alternative test recognizes the potential of income fluctuation if more than 90 percent of the remuneration results from remuneration based on output rather than hours worked.

We believe an income fluctuation test is appropriate as a safe harbor requirement. However, we question the wisdom of excluding the value of vehicles used to transport individuals and/or tools to a job site. In construction, there are a variety of independent contractor functions. The skill in using certain tools makes them valuable even if the tools themselves are not "significant" in relation to remuneration. The exclusion of vehicle value from the investment test may bar certain individuals, especially those starting in business, from the safe harbor protection even though they have a significant personal investment in their business activity. We believe a substantial asset test would be a legitimate test without excluding the value of vehicles.

The alternative income fluctuation test is based on the form of compensation. To qualify for safe harbor protection 90 percent of the remuneration for service must be based on output. Industry billing practices are often based on hourly compensation rates. Even for identifiable projects (e.g. installation of wiring or plumbing). The billing arrangement based on hourly rates is used due to an inability to estimate costs because of unforeseeable complications in the construction process. The procedure can also lower costs if a general contractor is well organized. As a result some functions will not be eligible for safe harbor inclusion. This is another example of why the common law principles must be recognized even though the safe harbor rules generally cover the most significant category of independent contractors in construction—equipment owner/operators.

Written contract.—AGC recognizes the beneficial aspects of requiring a written contract as a compliance mechanism as the fourth part of the safe harbor test. However, in construction independent contractors often deal directly with job site managers. Adding to the paper work of these individuals is not an insignificant cost. The difficulty in gathering information accurately from job sites should be underestimated. These practical difficulties of record keeping will undoubtedly lead to the failure of some firms to comply with the safe harbor by foregoing the written contract requirement even if the independent contractors would qualify under the substantive portions of the safe harbor rule. This is another example of the necessity of providing statutory recognition of the common law as an alternative to the safe harbor protection.

FILING PENALTIES

AGC recognizes information filings as a tax compliance device. While increased penalty coverage will undoubtedly improve tax compliance, the imposition of those penalties must be tempered by the recognition of the burdens of paper work under which businesses operate today. They should also be based on factual information as to the inadequacies of current penalties to increase tax compliance. Informational filing penalites were increased significantly in August of last year as part of the Economic Recovery Tax Act of 1981. We are not aware that the increased penalties enacted last year have been subject to a vigorous analysis by the IRS which shows their inadequacy.

COMMON LAW RECOGNITION

Recognition of the traditional common law principles is the most significant factor in preventing arbitrary reclassification attempts by the IRS. While a statutory safe harbor protecting equipment owner/operators is an essential element to a resolution of the independent contractor issue, the common law is needed due to the difficulty of drafting a safe harbor covering the variety of functions traditionally performed by independent contractors in construction.

H.R. 6311 contains a "no inference" clause stating that the failure to meet the requirements of the safe harbor classification of independent contractors shall have no implication on the classification of the individual under the common law tests. The no inference clause as structured does not preserve the common law principles from future regulatory changes. We suggest, as we did in our testimony before the Subcommittee on Select Revenue Measures of the Ways and Means Committee on July 17, 1979, that the no inference clause include the current IRS definition of independent contractors to preclude later attrition of the classification by IRS expansion of the present common law test enlarging the employee definition and narrowing the independent contractor definition.

STATEMENT OF THE ASSOCIATION OF AMERICAN PUBLISHERS, INC.

The Association of American Publishers, Inc. (AAP) is pleased to present this written statement of its position on the classification issues relating to independent contractors for Federal tax purposes. AAP is the general association of book publishers in the United States. It comprises Professional and Scholarly Publishing; College; International; Direct Marketing/Book Club; School; and General Trade divisions. Our over 300 member publishing houses produce the vast majority of general trade, educational, reference, professional and religious books published in this country and found in the nation's libraries as well as considerable related audiovisual materials.

AAP strongly supports the enactment of legislation which would provide a statutory safe-harbor definition of independent contractors. Many of AAP's members utilize the services of freelance readers, editors, designers, and other freelance workers who traditionally have been treated within the publishing industry as independent contractors for tax purposes and generally would be classified as independent contractors under applicable common-law principles. AAP believes that the availability of a statutory safe harbor for independent contractors will promote greater certainty in working relationships between publishers and freelancers and should improve the administration of our nation's tax laws.

In most cases, freelance workers in the publishing industry who qualify as independent contractors under common law principles (and who are not statutory employees within the meaning of Section 3121(d)(3) of the Internal Revenue Code) should be expected to satisfy the safe harbor tests set forth in the various Congressional proposals. However, with respect to the "income fluctuation" requirement set forth in some of the pending bills—including H.R. 6311, H.R. 5867 and S. 2369—there is language which might be interpreted, in an unintended manner, to deprive freelancers of their safe harbor status. The problem may be stated as follows: The "income fluctuation" test provides, in general, that more than 90 percent of an individual's compensation must be directly related to sales or "other output" rather than to the number of hours worked. The term "other output" is defined to include the performance of services but to exclude "piecework".

"PIECEWORK" DEFINED

As the term "piecework" is not defined in any of the existing proposals, AAP is concerned that this term might be construed to include the work product of freelancers in the publishing business, in which case such workers generally would not fall within the statutory safe harbor (because they rarely would be able to satisfy the alternative requirement for an investment in tangible assets). The legislative history underlying the bills currently pending in Congress indicates that the term "piecework" was not intended to apply to the output of freelance workers in the publishing business. The concept of excluding "piecework" from the definition of "other output" had its roots in Representative Rostenkowski's 1979 bill, H.R. 5460, which was not enacted into law but which is substantially similar to several of the current safe harbor proposals. The House Ways and Means Subcommittee on Select Revenue Measures prepared a Report on H.R. 5460, dated December 13, 1979 (the "1979 Subcommittee Report"), in which the term "piecework" was explained as follows:

"For purposes of the income fluctuation standard, piecework is intended to mean tangible output that is producd in standard or uniform units. Piecework commonly, but not exclusively, related to work performed in manufacturing and other production-type industries. By contrast, particularly in the service industry, a worker may be paid on the basis of output which is not piecework, because the output is not tangible and is not in uniform or standard units. An example of a worker who is compensated on a piecework rate basis would be a garment worker who sews sleeves on shirts and is paid on the basis of the number of sleeves that he or she sews. A trucker who is paid on the basis of the distance that goods are carried is paid on the basis of output. Similarly, loggers who are paid on the basis of standard quantities of wood, usually 'per cord' cut, hauled and delivered are paid on the basis of output." (1979 Subcommitte Report, p. 10.)

AAP believes that the foregoing excerpt from the 1979 Subcommitte Report supports the conclusion that the typical output of a freelancer in the publishing business is not "piecework", generally because such output is not "standard" or "uniform" and consists primarily of the rendition of services. AAP respectfully requests that similar language be included in the Committee Reports that are prepared in connection with the current Congressional proposals and, if possible, that the language be clarified—perhaps by adding another example—to confirm our conclusion that "piecework" was not intended to apply in the instant situation. A possible clarification would be to add the following sentence at the end of the paragraph quoted above: As a further example, freelance workers in the publishing business who are paid on the basis of completed projects such as evaluating or editing of manuscripts, composition, translation, indexing, designing type, text or artwork, and "paste-up" tasks, are paid on the basis of output.

House of Representatives,
Washington, D.C., May 17, 1982.

Hon. Fortney Stark,
Chairman, Select Revenue Measures Subcommittee, Longworth House Office Building, Washington, D.C.

Dear Pete: I am writing to you regarding the status of chore service workers as independent contractors, a subject on which I have communicated several times with the Select Revenue Measures Subcommittee in the last few years.

Through this state-run "chore services" program, as it is called in Iowa, individuals provide services to the elderly and disabled who, a limited or temporary basis, need assistance with small chores, such as minor household repairs and yardwork.

The providers of these services are often youths or other senior citizens who wish to earn a little extra money and help a neighbor in the process. Similar programs have been active in most other states, including a strong chore services type program in your home state of California.

Iowa has broadened their program in recent years to include non-professional in-home health services, such as physical hygiene, meal preparation and feeding, and monitoring of medication. The clients must be handicapped or 65 years or older. In addition, they must qualify as low income (41.2 percent of national medium income, $400/month for one, $523/month for two.)

As you know, the IRS ruling of 1975 that the States must begin withholding social security taxes for these workers, was put on hold by the Revenue Act of 1978, further extended in June of 1980, and will soon expire on June 30, 1982.

In the past, these workers have been wisely treated as independent contractors by the State of Iowa. Clearly, to consider them otherwise would threaten the continuation of this worthwhile program. I must stress that I support efforts by the IRS, and the Congress, to develop a rule that insures the prompt, equitable and accurate collection of federal taxes. However, it seems to me, that the classification of chore and in-home health service workers as "employees of the State" is inappropriate for this program, and would inflict a heavy paperwork and financial burden on this program's operating budget.

It is my understanding that the consideration of independent contractors and their classification for tax purposes will be coming up in the committee in the very near future. I am requesting your assistance in finding a permanent solution to the classification of these workers. Programs like the chore service program help to keep our elderly in their homes and in the long run may keep them out of federally assisted medical programs in hospitals and nursing homes. I am hoping we can work together on this urgent matter.

I look forward to your response.

With best regards, I am

Sincerely,

Berkley Bedell,
Member of Congress.

Central Michigan University,
Mount Pleasant, Mich., July 2, 1982.

Hon. Dan Rostenkowski,
U.S. House of Representatives,
Rayburn House Office Building, Washington, D.C.

Dear Mr. Rostenkowski: I write to urge your opposition to H.R. 6311: "The Independent Contractor Tax Classification and Compliance Act of 1982."

It is the position of Central Michigan University that the problem of non-compliance with the tax laws by certain groups of independent contractors must be addressed but in a more direct fashion than provided by H.R. 6311. Specifically, to provide IRS with the wherewithal to cross-check 1099 information reports, while at the same time increasing the penalty for nonsubmission of informational reports, would be a much more efficient and, in the long run, less costly way of addressing the problem. A second, albeit less attractive, solution would be to require a minimum withholding of income and SECA taxes.

Those attempts to address the compliance problem by simply altering employment status classification criteria will only force the IRS to attempt to overturn as many contractor relationships as possible, regardless of how legitimate, in order to increase compliance. To require a federal agency to disrupt and overturn historic relationships service recipients have with contractors in order to fulfill its mission is, in our view, disruptive, unnecessary and bad public policy. As stated in the attached summary of Central Michigan University's position, I believe the approach taken by H.R. 6311 and similar bills will seriously affect public higher education and its ability to fulfill its service mission.

Should you have any questions concerning Central Michigan University's position with regard to H.R. 6311, I sincerely hope you or your staff will feel free to contact me.

Sincerely yours,

Harold Abel, *President.*

CENTRAL MICHIGAN UNIVERSITY'S RESPONSE TO H.R. 6311, "THE INDEPENDENT CONTRACTOR TAX CLASSIFICATION AND COMPLIANCE ACT OF 1982"

A review of the controversy surrounding the classification of individuals as employees or contractors reveals several basic facts: (1) The GAO, IRS and Department of Justice have all determined there is substantial non-compliance with the tax laws by independent contractors; (2) the GAO, IRS and many knowledgeable critics believe the most efficient method of insuring compliance with the tax laws is through withholding by the payor; (3) beginning in the late 1960's, the IRS began a vigorous enforcement of the employment tax laws, which included requiring numerous independent contract relationships to be changed to employment relationships—the only relationship which currently allows withholding by the payor; (4) the Congress, in the Revenue Act of 1978, enjoined the IRS from making further regulations and rulings with regard to classifications of employment status. This prohibition is effectively removed by H.R. 6311, effective July 1, 1982.

The only reasonable assumption that may be made from the above is that on July 1, the IRS will begin a vigorous assault on any and all contractor relationships for the purpose of converting them to employment relationships, thus making them subject to the withholding laws. This assumption is given further support by the attitude of the IRS, as expressed in the remarks of the former Commissioner of the IRS as he left office, that his greatest disappointment during his tenure was the failure to resolve the classification problem and thus resolve the compliance problems of independent contractors. And, given the revenue maximization goals of the IRS, who can blame them from acting like the proverbial hungry fox who, having waited four long years outside, is now allowed into the hen house?

The objection that Central Michigan University has with H.R. 6311 is that it does not address the noncompliance problem directly. Instead, it requires that to accomplish its mission, a federal agency is required to overturn and regulate longstanding private employment relationships, an action which will have ramifications far beyond that of the withholding of taxes by the service recipient. The University believes that to attack a problem so obliquely is disruptive, unnecessary and bad public policy.

H.R., 6311 preserves the previous common law test and establishes and alternative "safe harbor" test which is actually a further specification of several of the twenty common law factors the IRS used previously (see Chapter 2, "Employer-Employee Relationships," IRS Training Manual 3142-01). The bill specifies that the safe harbor test is to be used for no other purpose that to determine employment status for tax purposes. CMU is confident that the safe harbor test will be used in this manner. However, it is only reasonable to assume that it will become the only test used for IRS purposes and, though somewhat more specific that the common law test, it is subject to wide interpretation. Yet, can one reasonably doubt what the IRS interpretation will be in applying the test? Moreover, though the safe harbor test may be used only for tax purposes, status determination for IRS purposes is the primary, and often controlling, factor for status determination for other purposes. Thus Congress may not logically stop the safe harbor test from becoming the controlling factor for most, if not all, status determination questions.

CMU believes that a vigorous effort by the IRS to convert large numbers of independent contractors to employees would seriously affect the ability of public institutions to carry out their continuing education mission. CMU's concern arises from its own experience whereby individuals, other than CMU employees, are contracted to address meetings; conduct clinics, seminars and workshops; serve as guest lecturers in courses on and off campus and even to teach an occasional extension course. CMU's decision to treat these individuals as independent contractors, using the common law test as a guide, has been upheld by state unemployment compensation boards and by the Social Security Administration. However, whether CMU could long withstand a relentless, vigorous attack by the IRS is doubtful, particularly since much of the fight would necessarily take place in the internal resolution system of the IRS.

To CMU, overturning the longstanding contractor relationship it has with such service providers would mean that the University would be liable for unemployment compensation, employer contributions for FICA and, as is required by Michigan law for every employee of a state college or university—retirement contributions. It is particularly ironic that retirement contributions would have to be made for this group since none would ever qualify for vesting under the retirement act. Should CMU be required to make such contributions, they will cost in excess of a quarter of a million dollars per year—a cost a public institution in Michigan can ill afford to bear. CMU believes that the relationship it has with such individuals is not unique, but is utilized by many, if not most, of the hundreds of public institutions which conduct continuing education programs of the size. Indeed CMU's programs would be considered quite modest in relation to the continuing education programs of some of the large institutions in the United States.

It is for the above reasons that CMU supports the concept of addressing the problem of non-compliance with the tax laws directly rather than indirectly through such machinations as allowing the IRS to change the employment status of individuals. And since the intent of the bill is to help the IRS maximize collections from this group, it can only work if the IRS is allowed to change the status of many, many individuals, which will have many unintended consequences.

In attempting to fashion a remedy for the problem, Congress should also ask how it is that since every service recipient is required to furnish a 1099 report on every contractor payment, the IRS cannot crosscheck these reports with individual returns to insure this income is reported. The same report could be crosschecked against SECA contribution files. In summary, it would appear that the wherewithal to solve the problem already exists in the IRS system.

STATEMENT OF RACHELLE B. BERNSTEIN, SENIOR TAX ATTORNEY, TAX POLICY CENTER, CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA

The Chamber of Commerce of the United States, representing over 240,000 businesses, trade associations, and local and state chambers of commerce welcomes the opportunity to submit testimony on classification issues relating to independent contractors.

SUMMARY

The Chamber commends Chairman Stark for holding hearings to examine the difficult problem of classifying workers for tax purposes as employees or independent contractors. Important tax consequences result from this classification. The Chamber supports legislation, like H.R. 6311, which provides certainty in making that classification by establishing a "safe harbor" test that businesses can rely upon to ensure that individuals providing services to them are self-employed independent contractors, without requiring withholding.

NATURE OF THE PROBLEM

A significant difference exists under current law between the tax treatment of employees and independent contractors. An independent contractor does not have Federal Insurance Contributions Act (FICA) taxes or income taxes withheld from his or her remuneration, but must make these payments directly to the Internal Revenue Service (IRS). The business that uses an independent contractor is not liable for tax under the Federal Unemployment Tax Act (FUTA), or for the employer's share of FICA taxes, and also avoids the administrative burden of withholding.

Under present law, an individual is considered an employee for withholding purposes if the common law relationship of employer/employee exists. The income tax regulations define this relationship in the following manner: "Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which the result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done." Treas. Reg. Section 31.3401(c)-1(b).

Thus, the determining factor under the common law test is the degree of control which the employer has over the worker.

The definition of employee for purposes of social security and federal unemployment taxes is virtually identical. The only major difference is that persons engaging in certain occupations are classified by statute as employees for social security tax purposes, regardless of how they would be treated under the common law test.

Even though the common law test has existed for many years and has been the subject of numerous court decisions, there are no clear and concise rules for deciding what degree of control is enough to make an individual an employee.

For example, the Internal Revenue Manual, which gives guidance for Internal Revenue agents involved in the audit process, contains a list of twenty factors, based on common law, which agents consider in making this determination. None of these factors is controlling, nor is the fact that a majority of them would indicate that a given individual should be classified as an independent contractor.

The lack of certainty in the common law test can be particularly hard on the business or individual paying for the services (the payor). It is the payor who must decide whether the person performing the services is an employee or independent contractor. If the payor decides the person is an employee, then the payor must generally withhold income and social security taxes from the amounts paid out and pay the employer's share of social security taxes and the federal unemployment taxes. If the payor decides the person is an independent contractor, the payor has no responsibility to withhold or pay employment taxes. The person receiving the payments, the payee, then has the direct responsibility for paying income and social security taxes directly to the IRS.

The consequences of mistaken classification can be serious. If a business has individuals reclassified as employees, that business would owe the income and social security taxes it should have withheld, along with the employer's share of social security taxes and federal unemployment taxes for all years not barred by the statute of limitations. The business would be able to reduce the amount due for the income taxes it should have withheld only if it can obtain sworn affidavits from the reclassified workers stating that they had paid their income taxes. The social security taxes paid by an independent contractor under the Self-Employment Contributions Act (SECA) cannot be used to offset the employer's share of social security taxes. The reclassified worker may request a refund of the excess of social security funds, but no effort is made by the IRS to notify the worker of this right.

The effect of reclassification may extend beyond employment tax problems. The law permits an independent contractor to establish a Keogh plan and contribute up to $15,000 a year into that plan, as well as contribute up to $2,000 a year into an individual retirement account (IRA). In addition to an employer-sponsored pension plan, an employee may establish only an IRA, which has a basic contributions limit of $2,000. An IRS determination that an individual is an employee would mean the earlier contributions to a Keogh plan were improper and, therefore, not tax deductible. It might also mean a reduction in the potential retirement savings of that individual.

A business could suffer a similar fate. ERISA requires that certain percentages of a firm's employees be included in a retirement plan in order for contributions to be tax deductible. The sudden reclassification of a number of individuals to employee status could cause disqualification of the plan. The additional costs of bringing the newly classified employees in the plan may cause the business to abandon it altogether.

In the late 1960's and early 1970's, the IRS increased its enforcement of the employment tax laws. Reclassification by the IRS from independent contractor to employee status resulted in large tax liabilities for many businesses which had traditionally treated their workers as independent contractors.

The Revenue Act of 1978 provided temporary relief from the effects of retroactive IRS employment tax audits to persons who, acting in good faith, had treated the individuals performing services for them as independent contractors. The act terminated pre-1979 employment tax liabilities for these taxpayers and also prohibited the IRS from issuing any new rulings or regulations on this issue until January 1980. This moratorium on the issuance of rulings and regulations by the IRS was later extended to June 30, 1982.

LEGISLATIVE SOLUTION

The Chamber supports creation of a broad "safe harbor" test, codifying the standards which evolved under common law and providing relief from the uncertainty created by IRS interpretation of the common law test. H.R. 6311 achieves this goal. The bill would not change the reasoning behind the classification of workers as either independent contractors or employees under the common law test. The amount of control exercised by the person from whom services are performed would still determine the proper classification. The bill would merely provide the self-employed and the business using the self-employed with a guarantee that, where the standards are met, the IRS would treat the worker as an independent contractor. Consequently, taxpayers would be relieved from IRS retroactive reclassification of independent contractors as employee which would result in retroactive assessment of employment taxes, double taxation where taxpayers paid withholding assessments for the same liabilites for which workers had paid income tax, overpayments of social security taxes where taxpayers pay FICA taxes with respect to workers who had paid SECA taxes, and disqualification or retirement plans.

The Chamber opposes imposition of withholding on independent contractors. Withholding does nothing to help a business solve the real issue—determining whether an individual is an employee or an independent contractor.

CONCLUSION

Many businesses and individuals have relied for years on the belief that the common law test established the individuals' tax status as independent contractors. Assertion by the IRS that many of these individuals were instead employees has brought increasing uncertainty to the common law test. Although the moratorium on IRS issuance of regulations and ruling in this area has provided a temporary solution to this problem, we hope that a permanent legislative solution can now be achieved.

We commend this subcommittee for holding hearings on this issue and extend the Chamber's support for legislation, such as H.R. 6311, creating a "safe harbor" test which provides certainty without extending independent contractor status to persons presently classified as employees and without imposing new withholding system on independent contractors.

COLLEGE OF AMERICAN PATHOLOGISTS,
Washington, D.C., June 8, 1982.

Hon. FORTNEY H. (Pete) STARK,
Chairman, Select Revenue Measures Subcommittee, House Committee on Ways and Means, Washington, D.C.

DEAR MR. CHAIRMAN: The College of American Pathologists in a non-profit organization with a membership of some 8,900 physicians, who practice the medical specialty of Pathology in various health care settings including the hospital setting; in teaching hospitals; in the private medical laboratory setting; and in the various medical schools located throughout the United States.

In behalf of a large number of our College members, who would be affected, we would like to take this opportunity to reiterate the strong concerns we have for pending legislation dealing with the independent contractor issue, including H.R. 4531, H.R. 4971, H.R. 5867, and H.R. 6311. With the exception of those pathologists who have a salary arrangement with the hospital they serve, a significant number of our members have a long standing contractual relationship with the hospitals they serve, and over the years have become recognized as independent contractors for tax purposes. The pending legislation, unless amended to provide for this unique situation, will threaten this physician-hospital relationship that has existed for many years.

During the hearings which are to be held on June 11, 1982, testimony will be presented by the American Medical Association. The College fully endorses this testimony and would like to urge your Subcommittee to act favorably upon the recommended amendments set forth in the statement.

The College would like also to submit the attached position paper which was adopted in April, 1981, and again urge your Subcommittee to look with favor to the views and recommendations contained therein.

The College would appreciate very much this letter and the attachment being included as a part of the official printed record of hearings to be held on June 11, 1982.

Sincerely,

JAMES D. BARGER, MD., *President.*

Attachment.

[College of American Pathologists, Washington, D.C., April 16, 1981]

MEMORANDUM

Re: Status of Hospital-Based Pathologists as Independent Contractors or Employees Under S. 8 and Similar Legislation

THE COLLEGE OF AMERICAN PATHOLOGISTS

Founded in 1947, the College of American Pathologists is a non-profit association dedicated to fostering the highest standards of education, research, and practice in the medical specialty of pathology. The College and its memberships of nearly 8,500 physicians who are board-certified pathologists are deeply concerned about any legislation that might classify hospital-based pathologists as employees rather than as independent contractors for federal income tax purposes.

The College of American Pathologists respectfully submits that S. 8 and any other legislation that attempts to distinguish between independent contractors and employees for federal income tax purposes should classify hospital-based physicians as independent contractors unless they are salaried employees of the hospital. Treating non-salaried, hospital-based physicians as independent contractors would comport with existing law, reflect the actual relationship between hospitals and such physicians, and accord with the purposes of legislation on the subject. The reasons for these conclusions are set forth in detail below.

A. CLASSIFICATION OF HOSPITAL-BASED PHYSICIANS AS INDEPENDENT CONTRACTORS OR EMPLOYEES UNDER CURRENT LAW

The Courts and the Internal Revenue Service recognize that the criteria applied in determining whether a professional is an independent contractor differ from those applied in the case of a non-professional. The high degree of judgment and education required of the professional makes it difficult for another to supervise the manner in which professional services are performed. Thus, as a practical matter, substantial weight is accorded to whether the arrangement between the professional and the person for whom he renders services contemplates that the professional is an employee or is an independent contractor. More specifically, the criteria stated by the Service are: (1) the degree to which the professional has become integrated into the operating organization of the organization for which he performs services, (2) the substantial nature, regularity and continuity of his work for the organization, (3) the authority vested in or reserved by the organization to require compliance with its general policies and (4) the degree to which the professional has been accorded the rights and privileges which the organization has established for its employees generally. Rev. Rul. 66-274, 1966-2 Cum. Bull. 466, and Rev. Rul. 72-203, 1972-1 Cum. Bull. 324.

The Internal Revenue Service has ruled that a physician director of a hospital pathology department is an independent contractor even though the hospital furnishes the space, facilities, equipment and technicians for the department. The key factors are that the pathologist has a right to control hours worked, is not paid a fixed salary, carries his own insurance, does not participate in the hospital's fringe benefit program for employees, and, subject to his obligation as director of pathology, is not prevented from performing services to others. Rev. Rul. 66-274, *supra*. Similarly, on substantially the same facts, the United States Court of Appeals has held that a hospital-based radiologist is an independent contractor rather than a hospital employee. *Azad* v. *United States,* 388 F.2d 74 (8th Cir. 1968).

The net effect of the foregoing is to permit a professional and the organization for which he performs services to reach an agreement under which the professional will be either an independent contractor or an employee depending upon the parties' wishes.

B. THE RELATIONSHIP BETWEEN HOSPITALS AND HOSPITAL-BASED PATHOLOGISTS IN PRACTICE

Generally, hospital-based pathologists who are not compensated on a salaried basis are regarded as independent contractors by hospitals. Frequently, their contracts explicitly so provide. Significantly, while requiring the pathologist to provide professional laboratory services, these contracts leave entirely to the discretion of the pathologist the manner in which such services will be provided. Thus, for example, it is the pathologist rather than the hospital who determines which procedures will be used to test for a particular condition.

C. CLASSIFICATION OF HOSPITAL-BASED PHYSICIANS TO COMPORT WITH LEGISLATIVE PURPOSE

The purposes of legislation to distinguish between independent contractors and employees for tax purposes suggest that there is no need to reclassify non-salaried hospital-based physicians as employees. The primary goal of this legislation is to avoid non-compliance with the tax laws by persons who contend, often erroneously, that they are not employees. Because such persons are treated by their employers as independent contractors, income and employent taxes are not withheld and paid to the Treasury. In practice, a large number of these persons either understate or do not report income from their services—with a significant loss of revenue to the Treasury as a consequence.

Hospital-based physicians are not the source of this problem. The evidence simply does not suggest that such physicians understate or fail to report income. In fact a substantial number of hospital-based physicians have organized professional corporations and, as a result, are paying or bearing the economic effect of both the employer's and employee's share of employent taxes. Accordingly, reclassification of non-salaried, hospital-based physicians as employees would not further the principal goal of the legislation in question.

D. CONCLUSION

There is little, if any, reason to treat non-salaried, hospital-based physicians as employees for tax purposes. They are not among the group that has abused the tax system and prompted the need for this legislation. Their status as independent contractors is well recognized in law and in practice. Accordingly, legislation should continue to permit the hospital-based physician to fix his status as employee or independent contractor by the agreement he has with the hospital.

STATEMENT OF HON. JAMES M. COLLINS A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TEXAS

Mr. Chairman, I commend this subcommittee for holding a hearing which addresses the issue of the reclassification of independent contractors. I believe there is a pressing need to provide the business community with a clear delineation between "independent contractor" and "employee."

This reclassification problem surfaced back in the 1970's when the Internal Revenue Service attempted to reclassify independent contractors as employees. This action was possible because clearly defined boundaries separating the two did not exist. These attempts by the IRS to reclassify workers resulted in an escalating number of audits of businesses. Moreover, businesses whose independent contractors were reclassified were liable for withholding on payments to independent contractors, social security taxes, and unemployment taxes which were not paid to the Treasury.

In addition to the increased number of audits and large retroactive tax assessments, businesses were placed in the position of having to defend themselves against the reclassification of their independent contractors by the IRS. Even if the businesses prevailed, they still faced enormous court costs.

Temporarily, this reclassification problem has been resolved because Congress allowed businesses to continue to regard their workers as independent contractors. However, this moratorium expires on June 30, 1982; four years after the initial measure.

Many companies utilize independent contractors almost exclusively. If these businesses suddenly had to regard their independent contractors as employees, the result would be devastating. At a time when we need to encourage the vigor of the private sector, clarification of the independent contractor status would have a positive effect.

As we will see today's hearing, there is a great need to resolve this issue once and for all. The end of the moratorium prohibiting reclassification looms before us, which makes passing legislation expeditiously so important. Let us not delay this important issue.

GIBSON, DUNN & CRUTCHER,
Washington, D.C., June 7, 1982.

JANE BOYLE, Esq.,
House Ways and Means Committee, Tax Attorney, Longworth House Office Building, Washington, D.C.

DEAR JANE: Thank you for your time in discussing the independent contractor issue with me on Tuesday, May 25, 1982. We would like to take this chance to respond to your invitation for comments regarding the proposed independent contractor legislation. In particular, we would like to comment on the retroactive reclassification of employment status by the I.R.S. and extension of Section 530 after the June 30, 1982, deadline. We propose that two steps be taken by the Committee:

First, the Committee should include in H.R. 6311, or similar proposed legislation, a provision that would prohibit the I.R.S. from retroactively reclassifying workers for all tax purposes, at least for taxable periods ending prior to the enactment of H.R. 6311, provided such workers reasonably believed they were independent contractors and their payors properly treated them as such under the provisions of Section 530. Also, businesses which reasonably relied on Section 530 should be immune from such reclassifications at least for taxable periods ending prior to the enactment of H.R. 6311. Exhibit "A", attached hereto, discusses the reasons supporting this proposal.

Second, Section 530 should not be allowed to expire should there be any delay in the enactment of H.R. 6311 or similar proposed legislation. Furthermore, if Section 530 is extended, a provision should be added to Section 530 (or set forth in any related Committee report) making it clear that workers who reasonably believed that they were independent contractors and were so treated by their payors under Section 530 can elect to be treated as independent contractors for tax purposes. Exhibit "B", attached hereto, discusses the reasons supporting this proposal.

We thank the Committee for this opportunity to comment on these important issues. Please call if we might provide any additional information or assistance.

Sincerely,

MARY JO DEZIEL.

Exhibit A

RETROACTIVE RECLASSIFICATION OF EMPLOYMENT STATUS

We are strongly in favor of including a provision in your Committee's proposed legislation, H.R. 6311, which would prohibit the I.R.S. from retroactively reclassifying workers for purposes of imposing tax assessments at least for taxable periods ending prior to the enactment of the legislation. Businesses should be immune from I.R.S. reclassifications for periods during which they properly relied on Section 530 of the Revenue Act of 1978. Similarly, workers should be immune from retroactive reclassifications for tax periods during which they believed, in good faith, they were independent contractors and their payors properly treated them as such under Section 530.

Since the late 1960's, substantial confusion has arisen over the distinction between employees and independent contractors for tax purposes. H.R. Rep. No. 95-1748, 95th Cong., 2d Sess. 3 (1978). Taxpayers raised the concern that the I.R.S. was applying the common law rules inconsistently and adopting standards which deviated from the common law standards. Id. During conference debate on the Tax Reform Act of 1976, the House and Senate Conference Committees recognized that I.R.S. employment status reclassifications were becoming an increasingly important problem and, thus, requested the Joint Committee on Taxation to study the employment status issue in preparation for new legislation in the area. H.R. Rep. No. 94-1515, 94th Cong. 2d Sess. 489, reprinted in [1976] U.S. Code Cong. & Ad. News 4118, 4193; S. Rep. No. 94-938, 94th Cong. 2d Sess. 604, reprinted in [1976] U.S. Code Cong. & Ad. News 3439, 4028. At this time, the conferees urged the I.R.S. not to assert any changed position on the employment status issue and not to issue retroactive revenue rulings in the area. Id.

The extensive confusion regarding the I.R.S. interpretation of common law employment status standards prompted Congress to enact Section 530 of the Revenue Act of 1978. This provision was designed to provide interim relief to taxpayers pending enactment of legislation eliminating the uncertainties surrounding the employment status issue.

Because Section 530 was intended to provide "breathing space" for taxpayers, of course, businesses should be immune from I.R.S. reclassifications for periods during which such businesses properly relied on Secton 530.

As for the workers, the I.R.S. has taken the position that such workers are not covered by Section 530. Thus, pending the enactment of clarifying legislation, workers have been required to make employment status determinations amidst the current confusion. For workers who acted reasonably and in good faith compliance with the law during this period, it would be unfair to permit the I.R.S. to penalize these taxpayers by retroactively reclassifying workers based on either newly-adopted standards or on the confused precedent which existed in the past. Workers who acted reasonably and in good faith relied on their employment status determinations when making substantial business and personal decisions which cannot be undone without disruption. For example, retirement income decisions affecting countless workers are dependent on employment status determinations made during this period. Moreover, it would be unfair to allow the I.R.S. to reopen those tax periods and impose large assessments against taxpayers who did not plan for these payments.

For example, we are currently representing a worker in an audit being conducted by the I.R.S. The I.R.S. has asserted that the worker is an "employee" rather than an "independent contractor" and, therefore, has proposed to determine his tax liability on that basis. The worker's payor has been properly treating the worker as an independent contractor unde Section 530. We are convinced the worker is an independent contractor under the common law and the I.R.S. has so treated the worker for all prior tax periods. Also, the worker has a good faith belief that he is an independent contractor. Nevertheless, absent a prohibition against retroactive I.R.S. reclassifications, the worker will have to endure lengthy and costly litigation to establish his independent contractor status under the ambiguous standards adopted by the I.R.S. even though the worker made a good faith effort to comply with the law.

Allowing the I.R.S. to make retroactive reclassifications would cause other problems in addition to the imposition of unplanned tax assessments against taxpayers. Such reclassifications would disrupt Keogh plans established by workers who reasonably treated themselves as independent contractors and would also disrupt business pension plans which have excluded from their coverage workers falling under Section 530. For example, in testimony given on Monday, April 26, 1982, by Gastar J. Lehr on behalf of the National Association of Independent Insurers, Mr. Lehr specifically noted the problem created by an I.R.S. allegation that a company pension plan might be disqualified by not including in the plan workers who were reasonably treated as independent contractors. Indeed, although Mr. Lehr stated that Section 530 had solved the problem temporarily, it is not clear that Section 530 does solve the problem by its terms and the I.R.S. has specifically suggested that as for employees (and their Keogh plan and other self employment tax treatment) Section 530 provides no assistance at all.

Also, if workers claiming to be independent contractors are challenged and subsequently treated as employees, such workers would be entitled to refunds for self employment taxes paid under the Self Employment Contributions Act in prior years. Although the workers would still be required to pay their share of FICA taxes, the employers' share will not be collectable because of Section 530 and, therefore, a significant net loss of tax revenue could result. In his testimony, the Treasury Department representative alluded to the FICA/SECA contributions differential and some of the problems it has caused. However, they have not focused on the serious problem which would be caused if workers whose payors are covered by Section 530, decide to apply for SECA refunds on the grounds that they really were "employees," It is hard to believe that the Treasury Department really proposes to treat workers whose payors are covered by Section 530 as "employees" even though their payors are exempt from withholding. However, as noted above, the I.R.S. has started such practice, and unless Congress acts, this disruptive and confusing situation will continue.

We believe the prohibition against retroactive reclassifications must cover more than umployment taxes under FICA and FUTA. The prohibition should be effective for all tax purposes including, for example, preventing the I.R.S. from disqualifying worker Keogh plans and other self employment tax treatment reasonably used by taxpayer workers.

Therefore, we urge that businesses be immune from I.R.S. retroactive reclassifications for periods during which such businesses properly relied on Section 530. Also, workers should be immune from I.R.S. reclassifications for periods during which such workers believed, in good faith, that they were independent contractors and their payors so treated them under Section 530. Furthermore, the prohibition should be effective for employment status determinations relating to all tax purposes and not merely for purposes of computing FICA or FUTA tax liabilities. You will note that we have proposed that the rule against retroactive reclassifications should apply for the period prior to the enactment of H.R. 6311 and not the period after the enactment of this proposed legislation.

Exhibit B

EXTENSION OF SECTION 530

We understand that due to the proximity of the June 30, 1982, deadline, and the preoccupation of the Committee with other pressing national issues, the clarifying legislation may not be enacted prior to the expiration of Section 530. We urge that Section 530 be extended until clarifying legislation is enacted. Although we recognize that Section 530 is merely a postponement of the problem, allowing Section 530 to expire would cause the situation to regress to the state of confusion which resulted in the enactment of Section 530 in 1978.

Furthermore, we urge the Committee to include as a provision in any Public Law extending Section 530 (or in any related Committee report) a statement that workers are entitled to treat themselves as independent contractors for all tax purposes if their payors are properly doing so under Section 530 and the workers have a reasonable belief that they are independent contractors.

It has come to our attention that Internal Revenue Service agents have been challenging the status of independent contractors and taking the position that these workers should be treated as employees. These workers whose status is being challenged have been assuming they were independent contractors because their payors have been properly treating them as independent contractors under § 530 of the Revenue Act of 1978.

Section 530 was enacted to provide "interim relief" for taxpayers involved in employment status controversies with the I.R.S. pending the enactment of legislation clarifying the employment status issue. Section 530 establishes "safe haven" rules which, when met, determine the employment status of workers involved in employment status controversies.

I.R.S. agents have taken the position that § 530 applies only to employers or payors and, therefore, does not estop the I.R.S. from challenging the employment status of workers. This view, however, frustrates the purpose of § 530. Section 530 was enacted to relieve taxpayers of perceived I.R.S. abuses of the common law rules regarding the employment status determination. H.R. Rep. No. 95-1748, 95th Cong. 2d Sess. (1978); S. Rep. No. 95-1263, 95th Cong., 2d Sess. 209 (1978). Releif from improper classification of workers is as important to independent contractors as it is to payors and employers, since the tax laws provide important benefits to independent contractors, such as the opportunity to provide adequate retirement income through a Keogh plan. If independent contractors are excluded from the protection of § 530, they would be exposed to the same I.R.S. manipulations of common law employment status rule that § 530 was intended to prevent.

If the I.R.S. position on § 530 is accepted, a large number of workers who assumed they were independent contractors under § 530's safe haven rules will become subject to improper classification as employees pursuant to I.R.S. manipulation of the common law rules. This would frustrate the Congressional intention of deferring I.R.S. employment status determinations until the anticipated legislation is enacted.

To support their position the I.R.S. agents cite the legislative history of § 530 and Revenue Procedure 78-35 which state that § 530 does not "change in any way the status, liabilities, and rights of an individual whose employment status is at issue." H.R. Rep. No. 75-1748, 95th Cong. 2d Sess. 7 (1978); Rev. Proc. 78-35. However, we understand that the Congressional purpose behind the "no effect on individuals" language was to assure that § 530 is not involuntarily imposed on workers in a manner which would cause adverse side-effects. For example, this language was meant to protect employees who would involuntarily lose their eligibililty for future social security benefits if they were deemed independent contractors pursuant to § 530. However, the "no effect on individuals" language was not meant to preclude workers from the protection of § 530 in appropriate cases.

To clarify the Congressional intent behind § 530, we recommend that the House Ways and Means Committee include in its Report recommending extension of § 530 the statement that workers, upon their election, are entitled to the protection of § 530's safe haven rules.

STATEMENT OF HON. RICHARD A. GEPHARDT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI

Mr. Chairman, I'm delighted that the subcommittee is holding this hearing today and hope that we'll soon see some action on this issue that has frustrated so many for so long. While the current freeze does provide some protection and stability, it leaves the two major groups involved in suspended animation. On the one hand, thousands of people who believe they are truly independent contractors cannot get a definitive and timely ruling on their status. It is subject to change with a minimum of notice. On the other side we have those at the Internal Revenue Service who contend that they could raise millions in new revenues if only we had an agreed-upon set of rules to govern the process.

As one who deeply believes that every American should pay his fair share of the tax burden, I am not insensitive to these complaints from our tax collectors. Their words are especially provocative during this time of record-shattering deficits.

It seems to me that any solution must meet two goals. It must give the contractors—some of whom can hardly qualify as tax sophisticates—a simple self-test that will provide an accurate determination of whether they are, in fact, independent contractors. Simultaneously, it must provide IRS with all the data it requires to insure that everyone is paying what is properly due. I think we have to recognize that we cannot enact legislation that will insure that all taxes due in this area—or any other area—will actually be collected. The best we can do is provide the government with the tools to improve its collection record.

After working on this problem for several years now, I think I've come up with a plan that speaks to both of these issues. It is included in H.R. 6311, which clearly tells everyone what the rules are without setting such complex standards that every independent contractor will have to hire a tax lawyer to be in compliance with the law.

It allows anyone who believes himself to be an independent contractor to administer a very simple test that could be printed on an index card to determine his situation. It provides the government with a list of virtually everyone who terms himself an independent contractor and thus provides a comprehensive basis for the enforcement and collection process. It is both simple and effective.

It seems to me that our debates within the Ways and Means Committee constantly attempt to respond to two seemingly opposite goals—simplicity and equity. We never completely meet both of them, but are sometimes more successful than others in defining a balanced solution.

I believe that H.R. 6311 reflects such a balance. it recognizes independent contractors are taxpayers just like everyone else despite their status and have the same obligation to comply with the law. But it also reflects the fact that many of them are part-time workers who don't have ready access to accountants and tax lawyers.

Our bill does not attempt to impose any sort of withholding on sales to those in the direct selling business. It recognizes that any such rule will certainly spawn further regulations and ultimately create a whole new subsection of the tax code. My fear is that any attempt in that direction could be the start of something big. That is why I think we should be very wary of any such approach.

We should also be careful not to endorse legislation that overpromises. We have often been guilty on this score in the past. There are some who would have us believe that the underground economy will shrink significantly if we impose new, stringent rules on independent contractors. I haven't seen evidence that would support that view. The sad fact is that a large segment of the underground economy is comprised of people who are committing illegal acts and then continuing their pattern of illegality at tax time. Nothing short of greater enforcement efforts by IRS will make a significant dent on this problem.

Independent contractor legislation will make life easier both for taxpayers and the IRS. That alone, I believe, is adequate reason to enact this legislation.

HENKEL, HACKETT, EDGE & FLEMING,
Atlanta, Ga., June 9, 1982.

Re Independent Contractor Legislation; Hearings; June 11, 1982.

Hon. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: The purpose of this letter is to encourage your support for a permanent legislative solution to the independent contractor classification problem which, as you know, has prevailed for a number of years. Specifically, we urge your support for the provisions of S. 2309, the "Independent Contractor Tax Classification and Compliance Act of 1982." This bill, introduced by Senator Dole, would restore certainty to the area of employee-independent contractor status determinations in a fashion which, we believe, would adequately protect the interests of all concerned. It would couple reasonable statutory "safe harbors" with increased information reporting and stiffer penalties for noncompliance. We strongly support the provisions of S. 2369 and urge that your Subcommittee give these provisions prompt and favorable consideration.

While we prefer a permanent and comprehensive legislative solution to the problem, should the Congress determine that it cannot enact such solution prior to June 30, then we urge that the relief provisions of Section 530 of the Revenue Act of 1978 be extended until such time as the Congress does enact a permanent solution.

This letter is submitted on behalf of Colonial Life & Accident Insurance Company of Columbia, South Carolina, and its independent sales representatives located throughout the United States.

Pursuant to your press release of May 13, 1982, we request that this letter be made part of the Subcommittee's official hearing record. Thank you.

Very truly yours,

STANLEY H. HACKETT.

HOME HEALTH SERVICES & STAFFING ASSOCIATION,
Washington, D.C., June 14, 1982.

Hon. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures, Ways and Means Committee, House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: The Home Health Services and Staffing Association wishes to present its views to the Subcommittee on Select Revenue Measures of the Ways and Means Committee on pending bills concerning the tax status of independent contractors. We request that this letter be incorporated into the record of the Subcommittee's June 11, 1982, hearings on this subject.

Members of the Home Health Services and Staffing Association (HHSSA) are investor-owned, tax-paying organizations, which provide both home health care services and supplemental nursing services through over 1,000 offices in 44 states.[1] In 1979, our members employed more than 160,000 persons in either a full-time or part-time capacity. In order to be eligible for membership in HHSSA, an entity must assume the legal obligations of an employer with respect to the professional and other personnel utilized in providing supplemental nursing services to hospitals, nursing homes and other institutions and home care services to individual patients. These obligations include the payment of FICA and FUTA taxes, workers' compensation and federal and state withholding.

We wish to comment on proposals to enact a safe harbor for independent contractors, because of our concern about the practices of certain businesses providing medical personnel services which improperly assert that their personnel are "independent contractors" and thus avoid the legal obligations of employers. In order to appreciate these concerns an understanding of the business practices of supplemental nursing services is necessary.

A supplemental nursing service (SNS) recruits and employs nurses and other health care personnel for the purpose of providing the services of such personnel to its clients, usually on a temporary basis. The SNS/Client arrangement usually falls within one of the following categories:

1. A health care facility utilizing SNS personnel to supplement and work along with, and as a part of, its regular staff.
2. A health care facility utilizing SNS personnel as special duty nurses for a particular patient.
3. An individual utilizing SNS personnel as private duty nurses, either at home or while in the hospital.
4. In some cases, an individual utilizing SNS personnel to provide a wide range of home care services, including nursing and other paramedical services authorized by a physician's plan of treatment and organized and supervised by SNS supervisory staff.

In all of these arrangements, the SNS assumes and exercises all of the attributes of an employer under common law. Of course, in the case of a facility utilizing SNS personnel to supplement its permanent staff, day to day supervision of SNS personnel is undertaken by the facility. Nevertheless, in every case, the SNS pays wages and bills its clients a service fee that covers all of the SNS' costs of doing business.

An SNS undertakes all of the obligations of an employer with respect to its personnel, including the following:

1. Determine pay rates and pay wages.
2. Withhold and pay all employee and employer payroll taxes required by federal, state and local law.
3. Pay premiums and provide coverage under all state workers' compensation, unemployment compensation and disability laws.
4. Provide various forms of fringe benefits, including sick leave, vacations and health insurance.

---

[1] Our members are: Alpha Nurses; American Medical Personnel Services, Inc.; Health Extension Services, Inc.; Kelly Health Care, Inc.; Kimberly Nurses; Manpower, Inc.; Medical Personnel Pool; Medox; Norrell Corp.; Nursefinders; Nurses PRN, Inc.; Olsten Corp.; Professional Nurses Bureau, Inc.; Quality Care-USA, Inc.; S.R.T. Med-Staff International; Staff Builders; Temporaries, Inc.; and Upjohn Health Care Services, Inc.

5. Provide various types of liability and bonding insurance covering its employees' activities.

6. Provide various types of orientation training and inservice programs.

7. Establish employment criteria and disciplinary policies and procedures.

8. Monitor and evaluate employees, and depending on the circumstances, undertake supervision of employees on assignment to clients.

From the above description, it can be seen that the working relationships in our industry almost always involve three parties: The worker who performs the service; the SNS which assigns personnel to a client's facility, exercises control over the worker, and pays the wages; the facility or individual client who receives the services, also may exercise control over the worker, and pays a service fee to the SNS.

Our concern is that some firms providing medical personnel services, characterizing themselves as "personnel referral agencies" rather than "supplemental nursing services", are using this three party relationship as a basis for claiming that their personnel are "independent contractors".

These "personnel referral agencies" often enter into arrangements with clients which are virtually identical to those described above. The typical example involves a firm that recruits nurses or other health care personnel for temporary assignment as supplemental staff to a health care facility. The facility client is billed a service fee based on the hours worked by such personel. The "personnel referral agency" pays wages to the personnel, also based on hours worked. Neither entity, however, withholds or pays payroll taxes, workers' compensation, or unemployment insurance premiums on behalf of the "independent contractors."

The "personnel referral agency" may enter into written agreements with the personnel and/or facility client, which describe its function as "providing a referral, billing and payroll service" for the individual worker. We know of some firms which even give personnel the option of being treated as "independent contractors" or as "employees" subject to tax withholding. Others maintain two separate but related businesses—one to recruit and assign "independent contractors" and another to recruit and assign "employees"—in both cases to the same types of clients.

In the foregoing examples, the personnel cannot be considered as "independent contractors", even under the most liberal common law tests. We believe that one or both of the other parties to such arrangements are "employers" under common law and that withholding and other tax and related payment responsibilities should rest either with the facility, which exercises the right of supervision and control, or the "agency", particularly if it pays the wages.

A distinction can be made between arragements involving a health care facility and those involving private patients. In the absence of control and supervision by a health care facility, a licensed registered nurse or other skilled professional, by virtue of training and experience, may well be able to function as an independent contractor. Normally, such services are arranged through a Nurses Registry established under state law.

However, a lesser skilled worker—such as a companion, sitter, home health aide or homeworker—probably lacks the training and experience required to determine and control independently the manner and method of his or her experience. When such an individual performs services for a private patient, therefore, it is reasonable to assume that either the patient or the "agency" is exercising sufficient control to characterize the worker as an "employee" under common law tests.

The bills pending before the Subcommittee on the tax status of independent contractors appear to be designed to address the conventional two party working relationship between a worker and the entity which receives and pays for the service. It is unclear how these bills' provisions would apply to the three party arrangements which characterize supplemental staffing services. HHSSA is therefore apprehensive that these ambiguities might result in the unintentional extension of independent contractor safe harbor treatment to the types of arrangements previously mentioned.

Numerous technical clarifications would be required to convert any of the pending bills into a suitable vehicle for addressing supplemental staffing relationships. HHSSA does not believe that it is the intent of these bills to extend independent contractor safe harbor treatment to personnel working within these relationships. We therefore suggest that the more efficient solution would be to clarify in any bill reported—or at the minimum, in legislative report language—that the safe harbor test only applies to the relationship between a worker and the hospital, nursing home or private patient client which actually receives the services. It would be necessary to state clearly that the enactment of such legislation would not affect or prevent a finding that, for tax purposes, such a worker is an employee of another entity which either controls or pays wages to the worker.

Clarification that safe harbor treatment does not extend to the relationship between a worker and a supplemental staffing service would be consistent with the view that a safe harbor standard for independent contractors should be confined to those situations where an individual is truly engaged in a business enterprise, such that his net income may be significantly different from his gross income as a result of investments or unreimbursed expenses. In these situations, imposing withholding and tax liabilities on any entity other than the worker would be clearly inappropriate.

In conclusion, HHSSA wishes to express its appreciation to the Subcommittee for the opportunity to present written comments on this proposed legislation, which is of direct importance to the supplemental nusing service industry. We hope to work with the Subcommittee staff in resolving the problems we have identified.

Sincerely,

JOHN B. SMITH, *Chairman.*

STATEMENT OF THE INDEPENDENT INSURANCE AGENTS OF AMERICA, INC.

The Independent Insurance Agents of America, Inc., (IIAA) is the nation's oldest and largest insurance producer group. IIAA represents fifty state associations, plus the District of Columbia, and over 1,200 local boards located in major cities and counties. We now number approximately 126,000 licensed insurance agents and brokers among our membership.

We are different from either life agents or property/liability agents who produce business exclusively for one company. As independent agents we represent a number of companies and can offer our clients a choice of coverages suited to their particular needs at the most advantageous terms. We not only advise our clients regarding coverage, but also suggest ways to cut premiums or reduce losses by improvements in loss control procedures and through other risk management techniques. Equally important, we represent our clients should a loss occur. We are, in short, independent contractors who want to be certain of that status under tax law and be permitted to retain it. Most of us have incorporated businesses and average approximately eight employees per firm with some of our members having well in excess of one hundred employees.

That is why IIAA supports enactment of the Independent Contractor Tax Classification and Compliance Act of 1982, H.R. 6311. The issue of classification of workers as either employees or independent contractors for tax purposes has had a long, and thus far, inconclusive history on Capitol Hill. IIAA vigorously opposed a Treasury Department proposal submitted by the previous Administration that would have levied a flat 10 percent withholding rate on independent contractors. The Congress rejected that proposal, and chose instead to postpone action on this important issue so that the ramifications of codifying a specific approach to the problem could be thoroughly explored, discussed and debated.

With the June 30 deadline on the current moratorium approaching, we urge you to act promptly and favorably on H.R. 6311. Short of enactment of this bill by June 30, we would urge a continuation of the moratorium on IRS action. We unequivocally oppose any action that would arbitrarily classify as employees, solely for the purpose of revenue enhancement, honest taxpayers who operate independent businesses.

There has never been any doubt under the tax laws that independent insurance agents are independent contractors. The independent agent is defined by the following characteristics:

1. The independent agent sells and services the policies of several insurance companies.
2. The independent agent solicits business for his or her agency, rather than for any single company.
3. The independent agent decides the location of the agency, the types of business to be conducted, the hours of operation, who is employed, their duties, work hours, and all other decisions relating to the success or failure of the business.
4. The independent agent, not the company, owns the business accounts (expirations) that he or she has produced.
5. The independent agent is usually incorporated and files quarterly estimated taxes based upon prior year's tax liability. The corporation withholds Federal and FICA taxes from employee's salary and deposits taxes on a semimonthly basis.

In only one technical way does the independent agent deviate from the general laws of agency. At various points in the insurance sales and service transaction the agent serves, at different times, as an agent of the insured and as an agent of the company. At no time does the independent insurance agent's relationship with his contracting companies even remotely resemble that of a salaried employee, particularly since the relationship is usually between a corporation and the contracting company. To imply or achieve such a relationship by a tax law revision would be to reject hundreds of years of common law and case law on the subject of the employment relationship between agents and principals.

It is unrealistic to assume that an independent agent subject to withholding on his or her commissions would not take on the characteristics of an employee. This subcommittee should understand that the vast majority of independent insurance agents built their businesses from the ground up, in the true entrepreneurial spirit that is the hallmark of the American free enterprise system. To turn such people into salaried employees with the stroke of a pen would be a serious social, political, and economic mistake. Further, how do you turn an incorporated, tax-paying entity into a "salaried employee"?

We will not belabor the specific points of H.R. 6311. The subcommittee, the full Ways and Means Committee and their respective staffs are intimately aware of the specific provisions of the bill, the history surrounding the controversy, and the current revenue situation this country is facing.

IIAA believes that the stiff penalties to businesses that don't fully report information to the IRS, together with a stringent and scrupulous application of the safe harbor tests stipulated by H.R. 6311, will ensure widespread compliance.

IIAA is concerned by certain provisions of H.R. 6300, the Tax Compliance Act of 1982, which stipulate stringent reporting requirements for payments to independent contractors, with no concomitant safe—harbor determination. Such an approach is piecemeal, and discriminatory. All aspects of the independent contractor issue must be dealt with in a comprehensive fashion. To require new penalty and reporting requirements without providing clear guidance as to the classification of independent contracts will undermine the very purpose of H.R. 6300—increased tax compliance.

STATEMENT OF THE INTERNATIONAL FRANCHISE ASSOCIATION

The International Franchise Association (IFA) is an organization representing more than 300 franchising companies and 150,000 franchised retail outlets in the United States and around the world. The IFA is recognized as the spokesman for franchisors in all legal and legislative matters affecting franchisors; and we are pleased to provide comments on, and support, H.R. 6311.

INDEPENDENT CONTRACTOR STATUS IN FRANCHISING

One of the cornerstones of franchising is the independence of a franchisee who can own and operate his own business while drawing upon the training, experience, and market expertise of the franchisor. The typical modern franchise is a contractual arrangement between two independent businesses in which the franchisee is licensed to use the trademark, trade name, and business system of the franchisor. In many cases, the franchisee is incorporated and frequently is the owner of several franchised units. Usually the franchise is granted for an initial franchise fee coupled with ongoing royalty payments. Royalties paid for the use of the trademark and the business system are typically stated as a percentage of the gross sales of the franchised business. In return for these fees, the franchisor typically provides a variety of services which may include market assistance, training, advertising, accounting services, quality control advice and other business consultation.

Franchising spans a surprising range of businesses in our economy; it is utilized as a method of distribution in as many as forty different industries. Statistics published by the Department of Commerce indicate that one out of every three retail dollars is spent through a franchised businessperson.

The independent status of the franchisee is vital to this fast growing innovation in American business. The independent franchisee is in every sense a modern entrepreneur, and it is this independence which motivates franchise owners and thus lends to the success of franchising.

H.R. 6311

The International Franchise Association supports the efforts of Congressmen Gephardt, Conable, Heftel and Hance to clarify this important area of the law. The IFA initially supported those efforts when legislation was introduced in the Congress by Senator Dole and Congressman Gephardt in 1979; and has recently supported Senator Dole's S. 2369, the Senate companion bill to H.R. 6311.

We believe that the franchisor-franchisee relationship clearly is and should remain one of independence. Only on rare occasions has the Internal Revenue Service challenged the independent status of the franchisee, but such challenges have occurred.

The Internal Revenue Service has set forth its views of the common law test of independence in enumerating twenty factors to be evaluated in making such a determination. Whenever these tests have been applied to franchise relationships, the conclusion has been reached that the franchisee is indeed an independent businessperson and not an employee of the franchisor. However, on occasion field representatives of IRS have given a strained interpretation to certain of these factors to support an argument that the controls exercised by a franchisor over certain activities of its franchisees should result in treatment of franchisees as employees for tax purposes. To prevent recurring attempts of this nature by the IRS, the IFA supports H.R. 6311, the "Independent Contractor Tax Classification and Compliance Act of 1982."

We do, however, note certain aspects of the bill as now proposed which require clarification. We believe that the franchise relationship should meet the safe harbor tests set forth in Section 2 of the bill. However, the application of the safe harbor analysis to the franchise relationship is not altogether clear as the bill is presently drafted.

Under the terms used in H.R. 6311, independent contractor status analysis often leads to an anomalous conclusion. For instance, the "payment" in the context of the franchise relationship is most evident in the form of franchise fees, advertising fees, and other fees paid by the franchisee to the franchisor in exchange for business services provided by the franchisor. It is not clear, under these circumstances, who would be the "service-recipient."

It is generally understood that an independent franchisee is an "independent contractor," operating his or her business pursuant to a written agreement with the franchisor. It follows that the franchisor should be a "service-recipient" under the bill. The definition in the Bill of a service-recipient is as follows: Service-recipient.—For purposes of this section, the terms "service-recipient" means the person for whom the service is performed.

From the proposed definition, the inference is drawn that the "service-recipient" pays for the services performed; however, franchisors do not "pay" in the normal sense for "services performed" by the franchisee. Franchisors are contractually bound in most instances to provide certain services to the franchisee. For those services and for the use of the trademark, it is the franchisee who makes payments to the franchisor. In these circumstances, it is readily apparent that the franchisor is not the agent or employee of the franchisee, and we know of no instance where that has been asserted. It is protection from the assertion that the franchisee is the employee of a franchisor that is needed, and which we believe should be clearly provided in the bill. To accomplish this, we believe that the definition in the bill of "service" should be clarified to include the business operations of licensees and franchisees using the licensor's or franchisor's trademark and business systems for a fee.

Assuming that this definitional hurdle can be cleared, either by amendment to the terms of the bill or by clarification of the term "service" in a Committee Report, so that franchisors would be "service-recipients" under the terms of H.R. 6311, we urge the Subcommittee to clarify in its report certain points regarding the application of the five-point safe harbor test to the franchise relationship.

In the first provision of the safe harbor test, "control of hours worked," we are concerned that the controls often imposed by a franchise agreement regarding the hours of retail operation of the business may deprive a franchisee of the safe harbor benefits. If a franchisor of a restaurant, muffler shop, hotel, or pet shop, for example, specifies that it must be open to the public during certain minimum hours, it should not deprive the franchisee of safe habor protection. This type of contractual arrangement usually leaves an individual free to set his or her personal hours of working in the business, and this should qualify under the control of hours test of the bill. Furthermore, if a franchise agreement requires that a business be open to the public for a minimum number of hours, that franchisee lend his "best efforts" to the success of the operation, and that the franchisee personally participate in the management of the business, does this arrangement remove "control" by the individual franchisee? We think it should not, and we urge clarification by adding language which stresses that the individual "controls the aggregate number of hours the individual actually worked. . . ." Our proposed language would assure that this section refers to individual control of individual work, and not the hours of a business operation.

The "place of business," "investment or income fluctuation," and "written contract" provisions of the bill have clear application to the business operations of independent franchisees. The final test of the safe harbor provision, "filing of required returns," is awkward when applied to payments between franchisors and franchisees. Most franchisors pay their franchisees nothing; the flow of franchise fees runs in the direction of the franchisor. The franchised business operates independently, generating revenues from which a percentage is taken and forwarded to the franchisor. The filing requirement is therefore quite unclear under the proposed bill, and may depend ultimately on whether, and how, a franchisor is defined as a "service-recipient."

CONCLUSION

The International Franchise Association supports the principles embodied in H.R. 6311. We believe that the somewhat awkward application of its terms to the franchise relationship can be easily clarified by minor additions to the bill and clear interpretations by the Subcommittee in its report. The independent nature of the franchisor-franchisee relationship is vital to this growing segment of the United States economy. The IFA applauds the efforts of Congressman Gephardt, Conable, Heftel, and Hance, and this Subcommittee in drawing a clear line between an independent contractor and an employee to prevent unwanted and unnecessary encroachment of these concepts by the Internal Revenue Service. Finally, we will be happy to provide any further comment or suggestions to the Subcommittee during its review of this legislation. We will be pleased to respond to any questions about the position set forth in this statement, or elaborate further upon it.

STATEMENT OF SIGMUND ZILBER ON BEHALF OF THE INTERNATIONAL TAXICAB ASSOCIATION

The International Taxicab Association (ITA) is pleased to have this opportunity to present its views concerning legislative proposals relating to the classification of certain workers as employees or independent contractors for purposes of Federal employment taxes.

ITA is the sole trade association of the taxicab industry, representing taxicab operators in every state and all major cities of the United States. The members of ITA own or control over half of the prinicpal corporations which operate taxicabs in the United States.

ITA wishes to offer its opinion on five somewhat similar bills: H.R. 4531 (Rep. Conable); H.R. 4971 (Rep. Crane); H.R. 5729 (Rep. Gephardt); H.R. 5867 (Rep. Guarini); and H.R. 6311 (Rep. Gephardt).

Each of these bills would amend the Internal Revenue Code to set up standards whereby certain workers would avoid classification as employees under the employment tax provisions. With some modifications, ITA is in favor of standards set forth in these bills.

The members of ITA have considerable familiarity with the problems this proposed legislation seeks to address. It is a well-established practice for the taxicab companies to lease their taxicabs to drivers for a fee. In accordance with a written lease agreement, the rental fee to the driver is comprised of a fixed amount plus a mileage charge. The drivers are free to transport passengers and to retain the fares collected, without being required to account to the companies in any manner. The drivers do not report to the companies as to their operation of the taxicabs, and the company does not supervise or review their activities. The drivers set their own hours and may terminate their services at any time.

Historically, the use of a lease system, in which the taxicab driver is an independent contractor, has been a common practice for many small taxicab operators, especially in the South, since the 1930s. In recent years, however, even major operators in large cities have adopted a lease system for part or all of their operations because of its advantages. A substantial portion of the taxicabs in the streets of such major cities as Miami, Chicago, Houston, and Los Angeles are now being driven by independent contractors. Taxicab operators have adopted the lease system primarily to effect a significant reduction in administrative costs, thereby partially counterbalancing the steady rise in general operating costs and permitting the continued provision of taxicab services without excessive fare increases.

As the law presently stands, the drivers under these standard leasing arrangements are not viewed as employees for purposes of Federal employment taxes. The driver's income is, however, taken into account for purposes of the tax on self-employment income.

The Internal Revenue Service has taken the position that, under the facts as I have described them, there is no common law relationship of employer and employee between the taxicab companies and their drivers. As a result, the IRS has concluded in Revenue Ruling 71-572 and many private rulings issued over the years that these leasing arrangements do not make the drivers employees under the relevant employment tax provisions.

This legal provision has proven beneficial to taxicab companies and drivers alike. It has provided flexibility and efficiency in taxicab operations, and has permitted the leasing practice to flourish with resultant economic benefits to companies, drivers, and the taxi-riding public.

Experience has shown that the lease system permits drivers to increase their earnings substantially through skill and hard work. The great popularity of the lease system among drivers results from the fact that it makes each driver an independent businessperson, who is responsible for the expenses of conducting his business and is entitled to retain all of the earnings he receives in serving the members of the public. The lease system, in which the driver is an independent contractor, is therefore truly an embodiment of the essence of the free enterprise system.

The leasing practice has reduced administrative costs to the companies and has provided substantial incentives to the drivers. The practice has also resulted in lower fares than would be the case under non-lease arrangements. These benefits would not be available were the companies required to treat the drivers as employees for tax purposes.

Each of the proposed bills to which I have referred contains provisions which retain the common law rules that have developed. The bills seek to provide, in addition, a clear statutory standard which, if met, would place certain workers outside the scope of the Federal employment taxes. The addition of such a standard to the body of the law adds a needed element of certainty and permits the structuring of business relationships in a manner which will avoid the employer-employee classification.

These bills are beneficial to the taxicab industry in that they do nothing to alter the existing law, as set forth in the IRS rulings. Moreover, they provide a clear guideline in the event the taxicab industry should ever seek to make alterations to its leasing arrangements or in the event the IRS should review its position and revise its rulings.

Specifically, ITA has these comments on the legislative proposals bearing on this question.

H.R. 4531, H.R. 4971, H.R. 5729, AND H.R. 6311

Each of these bills lists certain standards which must be met if a worker is to avoid classification as an employee. Each bill places these standards in subsection (b) of a new section, 3508, of the Internal Revenue Code. The versions of subsection (b) in each of the bills are fairly similar. In general, taxicab drivers operating under our leasing arrangements will have no difficulty in meeting any of the requirements in that subsection.

One of those requirements consists of a two-part test, stated in the alternative, involving the investment the worker has in the equipment he uses and involving the risk of fluctuations in the worker's income. As to the need for the worker to have a "substantial investment" in the assets, we believe the language of H.R. 4531 provides the most clarity. Among other things, H.R. 4531 states that the "substantial investment" test will be satisfied where the worker rents the asset and is entitled to a rental deduction. We believe it would be useful to have such clarifying language in the version of section 3508 which is ultimately enacted into law.

Another of the section 3508(b) requirements relates to a situation where the recipient of the worker's service provides a principal place of business to the worker. H.R. 4531, H.R. 4971, and H.R. 5729 do not treat the providing of a place of business to a worker as a critical factor where the worker does not perform his services at a "fixed location". We believe that this "fixed location" exception is useful in eliminating some uncertainty as to the application of this requirement, insofar as it relates to taxicab drivers. ITA recommends that the legislation which is finally adopted contain such a provision.

ADDITIONAL PROVISIONS IN H.R. 4971

Similarly, we believe it would be beneficial if new section 3508 contained some of the language found in H.R. 4971. The version of section 3508 appearing in that bill contains two alternatives to the subsection (b) requirements. under H.R. 4971, a worker will also avoid classification as an employee if he meets the tests of subsection (c) or subsection (d). We support the inclusion of these additional tests in new section 3508.

We would suggest two changes, however, to the subsection (c) requirements, as set forth in H.R. 4971, relating to the worker's investment in and maintenance of the assets he uses to perform the services. Here, too, we believe it should be made clear that the "substantial investment" test can be satisfied when the worker leases the assets.

As to the H.R. 4971 requirement, in new section 3508(c), that a worker must be responsible for the maintenance of the assets, we would prefer that clarifying language be added to make this provision compatible with the current practice under the taxicab industry leasing arrangements. Those leases contain a provision requiring the driver/lessee to return the vehicle in the condition in which he received it. Of necessity, such a provision imposes a duty on the part of the driver to provide some degree of operational maintenance, although no one would suggest that this duty extends to extensive repairs of the vehicles. We do not believe there should be a requirement in the statute for a lessee of equipment to provide other than such minor operational maintenance. The responsibility for major repairs and overhauls is a heavy duty to place on a worker, and it is a matter which really has no direct bearing on the question of whether or not he is an employee. We submit that the duty to maintain leased assets is a subject best left to the agreement of the parties. It should not be made a matter of critical importance for the purposes of this legislation. It may be useful, in view of the potential for widely varying interpretations as to the scope of the term "maintenance", to give some thought to deleting this requirement altogether.

In addition, we would suggest a minor modification to subsection (d) of section 3508, as it appears in H.R. 4971. That subsection permits a worker to avoid employee status when he has performed similar services for five or more payors during the year. The meaning of the word "payor" is not clear here and, to be consistent with the rest of the statute, should probably be changed to "service recipient" or some similar term. Since taxicab companies do not make payments to drivers under the standard leasing arrangements, it is possible that subsection (d) could be viewed as inapplicable to taxicab drivers. We therefore believe that some clarification is warranted to avoid the unnecessary exclusion of this group of workers.

H.R. 5867

The section 3508(b) requirements contained in H.R. 5867 vary somewhat from those in the other bills touching on this question, and ITA is of the view that the H.R. 5867 version of 3508(b) would raise serious question as to the application of the provision to taxicab drivers. In particular, we are concerned that the alternate requirements of section 3508(b)(2), as found in that bill (i.e., the "place of business" requirement, the "tangible property" requirement, and the "sales" requirement), are not broad enough to permit our members to attain independent contractor status. It is therefore our recommendation that this version of section 3508(b) not be enacted.

ADDITIONAL PROVISION IN H.R. 4531

It is the opinion of ITA that the legislation, as finally approved, should contain the provision, currently in H.R. 4531, relating to Tax Court appeals. Under this provision, an adverse IRS determination as to a worker's status as an employee for purposes of Federal employment taxes may be appealed to the United States Tax Court, without the need to pay the tax first. We view such access to the Tax Court as essential in view of the developing controversies in this area of the law.

We note that on May 15, 1982, the Section of Taxation of the American Bar Association, in stating its approval of legislation such as that discussed herein, expressly recommended that the jurisdiction of the Tax Court be expanded to include employment tax controversies.

CONCLUSION

Mr. Chairman, the International Taxicab Association is hopeful that Congress will enact employee-classification legislation which contains the best features of the bills under consideration and includes the modifications we have suggested. I respectfully urge speedy and favorable consideration of such legislation.

STATEMENT OF THE INTERSTATE CONFERENCE OF EMPLOYMENT SECURITY AGENCIES, INC.

The Interstate Conference of Employment Security Agencies, Inc. (ICESA) is an organization whose members administer the state unemployment compensation laws and public employment system in the fifty states, the District of Columbia, Puerto Rico and the Virgin Islands. We appreciate the opportunity to present our views concerning the establishment of legislative standards for clarifying which workers are independent contractors.

State unemployment compensation laws generally contain the same coverage provisions as the Federal Unemployment Tax Act, which is administered by the Internal Revenue Service. Whether a worker is covered by both the state unemployment compensation law and the Federal Unemployment Tax Act depends on the existence of an employment relationship. A fundamental change in this concept in federal law, would, as a practical matter, have to be followed by the states. Inconsistencies between the state and federal criteria would cause confusion among employers, an increase in recordkeeping, and result in incorrect tax payment to both the states and the federal government. Due to these difficulties the states would be under tremendous pressure to follow the federal criteria.

We recognize the need for greater predictability in determining independent contractor status. However, as administrators of the unemployment insurance system our first concern is that the conditions which are adopted for according independent contractor status to individuals may be manipulated in a manner which would result in the shift of workers who are currently acknowledged to be employees to self-employed status. Such a shift would have serious consequences for both the economy and the lives of workers who could lose the protection of unemployment insurance benefits and other worker protections which are based on the concept of employment.

We believe that the various proposals under consideration would have, to varying degrees, much broader implications than are intended. We would prefer to see narrowly drawn exclusions specifically restricted to named occupations. Such an approach would have a high degree of certainty of application and would assure that only those occupational groups which Congress intends to address are affected. Limiting the exclusions to clearly defined groups would also allow this subcommittee to consider accurate estimates of the consequential effect on federal revenues in your deliberations.

If you choose to establish standards for determining whether workers are independent contractors, however, we urge you to give favorable consideration to the criteria which are set forth in H.R. 5867. This bill eliminates many of the opportunities for manipulation of working conditions in order to switch employees to independent contractor status that we see as possible in other proposals under consideration.

Four bills currently under review—H.R. 5867, H.R. 4531, H.R. 4971 and S. 2369—set standards (some are alternatives) regarding: 1) the individual's control of the hours worked; 2) the place of business; 3) an investment in tangible assets; 4) income fluctuation; and 5) requirement for a written contract. Each of these standards is discussed briefly below.

Control of hours worked.—The increasing popularity of "flextime" demonstrates the modern employer's willingness to allow workers to schedule their own working hours. Many employers would likely also be willing to give up control of the number of hours worked as long as specified duties are performed.

Place of business.—The principal advantage of H.R. 5867 over the other proposals is in the "place of business" test. In order to satisfy that alternative test, H.R. 5867 requires the individual to have a principal place of business which is not in his home nor provided by the service-recipient. The other proposals contain "place of business" tests that would be satisfied if the worker rents the place of business from the service-recipient.

Allowing rental of the place of business from the service-recipient is especially vulnerable to manipulation. Under current law and practice we see the alleged rental of beautician and barber chairs, vehicles, secretarial desks and typwriters and space in auto repair shops. In these cases the rental is usually deducted from income generated by the service performed and is controlled and accounted for by the employer. The worker then receives a net payment after the deduction. In most cases the rent charged is based on income or production rather than a flat rate based on a time period as in true rental agreements. There is rarely a bonafide rental agreement with the worker having a legal right of access to the property or space "rented." It is only a short step to rent space to a factory worker on a production line.

Even though H.R. 5867 is a substantial improvement, there is one possible loophole in the place of business test—the use of the term "service-recipient." In occupations where service is provided to individuals (e.g., barbers, auto mechanics), is the customer or the owner of the premises where the work is performed the "service-recipient"? If the customer is the "service-recipient" then the shop owner can provide the place of business—with or without rent being paid—and the worker can still meet the place of business test for independent contractor status.

The drafters of the various proposals clearly intend the term "service-recipient" to refer to the shop owner, not the customer, as in the illustration above. This is apparent because a written contract is required between the individual and the service-recipient, to satisfy an additional test. Problems of misinterpretation and possible manipulation are bound to arise, however, due to the plain words of the definition.

Tangible investment.—H.R. 5867 also improves the tangible investment test by excluding vehicles which are used to transport the individual. Since most workers use a vehicle to get to their jobs, without this exclusion a vehicle could be used to satify the investment criterior. H.R. 5867 also requires that more than one-third of the value of the service be attributable to the tangible property provided by the individual. The other proposals simply require a substantial investment in assets used in connection with the performance of service.

A basic problem with the "substantial investment" element is that the investment must be made by the worker, but the employer/service-recipient has the responsibility to prove it. If it is a true investment in facilities by the worker, the service-recipient, in many cases, would have no way of knowing about it. This is particularly true in situations where the issue arises from an audit after the worker is not longer associated with the company. Employers have argued that substantial investment includes such items as a deck at home, luggage, sample racks, typewriters, adding machines, craftman's tools or numerous other assets.

Income fluctuation.—The "income fluctuation" criterion is fairly similar in the various proposals. The individual must risk income fluctuations because more than 90 percent (95 percent after 1983 in H.R. 5867) of the remuneration is related to sales or other output rather than the number of hours worked.

This condition would be easily satisfied by changing the pay base from hours actually worked to the completion of prescribed duties which would be related to "other output" which is defined as including the performance of services. The completion of prescribed duties could include a bookkeeper posting a journal, a painter painting a house, managing a hotel or apartment house, or customers serviced. The list is endless and only subject to the imagination; but nowhere is the profit concept considered or must there be a risk of loss.

Both H.R. 5867 and H.R. 4531 exclude "piecework" from "other output" in applying the income fluctuation test. It is very difficult to distinguish payment to a logger for cutting a cord of wood from a payment to a garment worker for sewing a dress. The former is said to be output and the latter, piecework. Such a distinction would be very difficult to apply in practice.

Written contract.—The requirement for a written agreement between the worker and service-recipient can be satisfied simply by stating the modified working conditions in contract form. This element of the criteria is a clerical one which does not determine the nature of the relationship between the worker and business proprietor.

Historically, the concept of an independent contractor equates to being in business for oneself. Ideally, an independent contractor holds himself out to the general population or the business community in an identifiable way as being in business and ready to provide a particular kind of service to customers or clients. None of the bills require any demonstration of an independent business venture, yet that is the one factor of the common law test which is easiest to demonstrate and most difficult to manipulate.

In previous hearings, the Internal Revenue Service stressed the disappointing level of compliance with our tax laws among persons classified as independent contractors compared to employees subject to the withholding system. We support the elements of this legislation which seek to improve the level of compliance among independent contractors. However, if standards are adopted which result in the switching of many employees to independent contractor status, the loss of revenue to the financially troubled state and federal unemployment trust fund accounts could be substantial.

An important additional consideration is tax support for the social security system. Even if every redesignated former employee fully complied (which probably will not happen), revenue from this expanded class would be reduced by 25 percent while benefit obligations remain the same.

In summary, we believe that the problems surrounding determination of independent contractor status will best be resolved through regulated application of the common law definition of employment, with statutory exemptions for particular industries or occupations. If you choose to adopt standards for determining independent contractor status, we urge you to favorably consider the more tightly drawn tests of H.R. 5867. We also urge you to modify H.R. 5867 by closing the potential loophole in the definition of service-recipient and to clarify the difference in piecework and other output. We believe that the criteria contained in other legislative proposals would cause the reclassification of many employees to independent contractor status with the resulting loss of the many worker protections which are dependent on the employment relationship.

We again thank you for the opportunity to present our views on this issue.

Statement of Robert D. Bannister, of the National Association of Home Builders

SUMMARY

I. NAHB concerns

NAHB applauds efforts toward developing a workable rule governing independent contractor status for individual workers. We are concerned that the safe harbor tests contained in H.R. 6311 and S. 2369 fail to recognize the traditional contractor/subcontractor contractual relationship within the homebuilding industry.

Subcontractors of homebuilders do not clearly qualify as independent contractors under the safe harbor tests.

NAHB urges modification of the current legislation to assure that homebuilders and subcontractors fall within the safe harbor test.

II. Customary practices in the housing industry

Homebuilders are generally small businessmen with few employees. The homebuilder is the developer/contractor. As such, he contracts directly with subcontractors or through a general contractor who then contracts with subcontractors. Generally, more then 12 sub-contractors are involved in building one home. Subcontractors are typically framers, drywall men, carpenters, painters, plumbers, electricians and all other skilled tradesmen. The general practice is to pay subcontractors on a project basis rather than a hourly basis. Subcontractors are responsible for income and payroll tax withholding for employees.

III. Difficulties with H.R. 6311 and S. 2369

The safe harbor test presents the following difficulties:

1. *Control of hours.*—Since subcontractors must fit their work into a sequence in the construction process, subcontractors do not totally control the scheduling of their hours. The scheduling is controlled by the general contractor, who may also be the homebuilder. The safe harbor and the exception contained in Section 2(c) (4)(C) related to coordination of work does not appear to apply to subcontractors since their work is coordinated by the general contractor.

2. *Place of business requirement.*—The work environment for subcontractors is the job site/subdivision. Many subcontractors have an independent office or operate out of their home. However, since the homebuilder owns the job site, it is uncertain as to whether subcontractors would fall within the place of business safe harbor.

3. *Investment or income fluctuation requirement.*—Since the assets of subcontractors are often only their tools, and since income fluctuation is based upon risk inherent in the homebuilding industry, rather than sales performance, subcontractors may not be covered in the investment or income fluctuation safe harbor.

IV. Suggested modifications

NAHB assumes that the uncertainties in the current bill are inadvertent, due to the special nature of the homebuilding industry, rather than a desire specifically to exclude legitimate subcontractors. NAHB suggests the following changes:

1. *Control of hours worked.*—The current test dealing with the control of hours worked is of major concern. There is uncertainty about the application to homebuilders of the exception for sequential jobs. Clarification that subcontractors, who must fit into the construction process, are covered under the safe harbor test is nec-

essary. To achieve this objective, NAHB recommends that the phrase requiring coordination by someone other than a service-recipient be deleted and the following language added to Sec. 2(c) (4)(C), "the coordination of the performance of service with the performance of other services as determined by another person."

2. *Place of business.*.—The ambiguities surrounding the place of business safe harbor should be clarified. To establish that temporary use of a trailer or other facilities on the job site would not be a principal place of business provided by the service-recipient, the following language should be added at the end of Sec. (b) (2)(B) ", or if the individual is provided temporary use of the facilities on the site where the work is performed." In addition, report language indicating that work performed at a construction job site does not constitute a principal place of business should also be included.

3. *Investment or income fluctuation.*—To ensure that workers on construction sites qualify for the tangible assets requirement, an additional provision should be added to the provisions dealing with definitions and special rules. This addition would be Sec. 2 (c)(5) "Special Rule for Determining Investment or Income Fluctuation.—For purposes of Sub-section (b)(3) the individual shall be deemed to have a substantial investment in assets if the individual furnishes the asset or the assets customarily used in the performance of the service."

STATEMENT

NAHB is a trade association of the housing industry of the United States. Our membership, engaged in the building of the homes of America, comprises more than 114,000 members and more than 723 state and local associations situated throughout the country. The classification of workers as independent contractors for tax purposes is of vital concern to NAHB and its members. NAHB applauds efforts in both the House and the Senate to establish workable rules governing independent contractor status for individual workers in a variety of industries.

NAHB Is concerned that the safe harbor tests contained in H.R. 6311, introduced by Representatives Congressman Gephart and Representative Conable, Heftel and Hance and S. 2369, the companion Senate bill, do not recognize traditional business practices in the homebuilding industry. As a result, homebuilders may, if this legislation in its current form is enacted, be one of the few industries required to rely upon the confusing and ambiguous common law test to establish that subcontractors are, in fact, independent contractors and not employees of the homebuilder. NAHB urges modification of the current proposed legislation to assure that homebuilders and subcontractors who perform work for homebuilders fall within the safe harbor test.

The development of useful rules to classify individuals as independent contractors is a difficult task. Congressional action on this issue began in 1978 in the 95th Congress and has extended through the 96th Congress and continues in the 97th Congress. Without further Congressional action, the interim relief and prohibition on the issuance of new rulings and regulations by the Internal Revenue Service will expire on June 30, 1982. In resolving this issue, NAHB wants to be sure that the Ways and Means Committee and the Congress is fully aware of the special needs of the housing industry.

CUSTOMARY PRACTICES IN THE HOUSING INDUSTRY

Homebuilding is a diverse economic activity. Homebuilders range from small one-man companies to large developers. But, the typical builder of single family homes is a small businessman. He employs fewer than 10 persons. The employees typically are office personnel, laborers, and customer service persons. The laborers generally work at the job site doing rough work such as hauling materials, and clean-up work. Customer service personnel are semi-skilled individuals who may perform minor repairs on completed homes in response to customer concerns. These personnel are employees on the payroll of the homebuilder.

Two-thirds of all single family builders construct 25 units or less per year. Obviously, with only a small staff of employees, the homebuilder must rely upon independent contractors to perform the majority of the homebuilding work.

In the homebuilding industry, the contractual relationships begin first with the developer who is the homebuilder. He is responsible for accumulating the land and putting the development package together. The next entity in the chain is the general contractor. The general contractor may be the same entity as the homebuilder, but this is not always the case. The general contractor may be a separate corporation or person entirely unrelated to the developer, or it may be the developer operating out of a separate corporation. Unless the developer operates as a general contractor in the same entity, the developer and general contractor will enter into a contractual relationship which is clearly not an employer-employee relationship.

The general contractor will then enter into contractual relationships with other subcontractors such as floormen, drywall men, carpenters, painters, plumbers, electricians, and all other skilled tradesmen. This relationship is generally spelled out in a written contract in which payment is made to the subcontractors on a project basis rather than upon the number of hours worked.

While the subcontractors are independent from the general contractor, the general contractor must coordinate each aspect of the job in a sequence. This control is inherent in the homebuilding process. Foundations must be laid, followed by general frame work, followed by electrical work, followed by plumbing, followed by heating and air conditioning duct work, followed by installation of insulation, followed by carpentry work, followed by flooring, followed by finish drywall, followed by painting and installation of appliances, cupboards, cabinets, etc.

Different independent contractors handle all of these activities. The coordination of the performance of service will, therefore, be under the control of the general contractor who may, or may not, be the developer.

The subcontractors are responsible for their employees on an hourly basis as well as all recordkeeping for income and payroll tax purposes. The responsibility of the general contractor and ultimately the developer is merely to pay the subcontractor for work completed in accordance with the terms of the contract.

This is the long-standing practice, and a reclassification of subcontractors as employees would cause havoc within the homebuilding industry.

The subcontractors will perform the majority of their duties at the job site. Some of the subcontractors will be working at other jobs. These other job sites may be by the same developer, or they may be for different developers. The office of the subcontractor may be the subcontractor's home, or it may be a general business office. Often, the general contractor or the developer may provide a trailer or other temporary shelter at the job site for general use by supervisory personnel, including subcontractors.

The tools of the trade of many subcontractors, such as bricklayers, carpenters, drywall men, and to some extent plumbers and electricians, may not be substantial. Tools such as a hammer or trowel, are not costly. The most substantial investment which a subcontractor may have is the vehicle carrying his tools and transporting him to and from the job site. Obviously, subcontractors risk temporary economic fluctuation in accordance with the economic condition of the homebuilding industry, which at the moment, is to say the least, not good. The remuneration of subcontractors is generally based upon output rather than hours worked and will fluctuate depending upon the available jobs.

EFFECT OF H.R. 6311 AND S. 2369 UPON HOMEBUILDERS

Under the foregoing facts, there are serious questions about whether the relationship between homebuilders and their subcontractors would qualify for the safe harbor test in the proposed legislation.

General comment

The legislation defines the "service-recipient" as the "person for whom the services is performed." Because the developer and general contractor are two separate entities, the ultimate service-recipient in a homebuilding setting is the developer. However, the general contractor is also a service-recipient with respect to subcontractors. This relationship is important in analyzing the test proposed in both H.R. 6311 and S. 2369.

Control of hours

Under control of hours worked test in H.R. 6311, to qualify as an independent contractor, the individual must control both the number of hours worked and the scheduling of the hours worked. Obviously, subcontractors do not control the scheduling of their hours worked. The special exception set forth in Sec. 2(c)(4)(C) seems to recognize the difficulties with coordinating jobs in a construction setting. This exception permits an individual to be considered to be an individual contractor where work performed must be coordinated with other work performed. This exception is, however, applicable "only if such coordination is done by a person other than the service-recipient or a related person."

The requirement that the coordination be done by person other than the service-recipient appears to exclude subcontractors of homebuilders from the general exception. This is because of the ambiguity surrounding the definition of service-recipient. The general contractor is obviously a service-recipient vis-a-vis the subcontractors.

Since the general contractor controls the scheduling of the work of subcontractors, these individuals would not qualify under the control of hours test. The situation becomes even more difficult to qualify in situations when the developer and the general contractor are related to parties, since the developer will be controlling the work of the subcontractors.

Place of business requirement

The second principal requirement is that the service-recipient not provide a principal place of business to the individual independent contractor unless the independent contractor pays a fair rental for the place of business. A special exception brings sales personnel operating out of an office under this safe harbor. The exception allows a service-recipient to provide the individual a place of business "if substantially all of the service performed by the individual for the service-recipient is not performed at such place of business or any other place of business provided by the service-recipient."

This exception will cover many sales personnel who typically operate in a non-office setting. But for subcontractors at a construction job site, it is unclear as to whether such individuals would fall within the principal place of business requirement since the worker's primary activities are conducted at the construction site which is owned by the service-recipient. Additional ambiguity is created when the developer or general contractor provides a trailer at the job site for use by subcontractors.

Investment or income fluctuation

A third safe harbor test is the requirement that the individual have substantial assets or that the individual risk income fluctuation because remuneration is based upon output rather than number of hours worked. The requirement that tangible assets be both significant in value and substantial as compared to the remuneration appears to exclude many subcontractors since their assets are often small in value. The income fluctuation test may cover subcontractors who work on a output basis. However, income fluctuation is based primarily upon risk inherent in the cyclical nature of the homebuilding and construction industry rather than sales performance.

SUGGESTED MODIFICATIONS

NAHB is pleased at efforts to clarify the status of independent contractors. Establishment of a workable safe harbor test would eliminate many uncertainties which are inherent in the common law.

NAHB is also aware of the Chairman's concern, expressed in the Senate hearings, over the need to encourage tax compliance. NAHB's members pay their taxes. Those who fail to report income or seek to convert personnel expenses into deductible business expenses merely increase the tax burden on taxpaying Americans. Most of the extensive business deductions referred to by the Chairman are related to the part-time sales area. The homebuilding industry is not a part-time occupation, and the individuals—developers, contractors, and subcontractors—are engaged in their work for profit, not for tax deductions.

Since the desire of the sponsors of the safe harbor legislation is to provide relief for those industries which have traditionally operated as independent contractors, NAHB assumes that the ambiguities in the current proposed legislation are the result of failure to understand and appreciate the relationships within the homebuilding industry, rather than a desire to specifically exclude homebuilders from the safe harbors.

With this view in mind, NAHB submits the following suggested changes:

1. *Control of hours worked.*—The current test dealing with the control of hours worked is of major concern. There is uncertainty about the application to homebuilders of the exception for sequential jobs. Clarification that subcontractors, who must fit into the construction process, are covered under the safe harbor test is necessary. To achieve this objective, NAHB recommends that the phrase requiring coordination by someone other than a service-recipient be deleted and the following language added to Sec. 2(4)(C), "the coordination of the performance of service with the performance of other services as determined by another person."

2. *Place of business.*—The ambiguities as to the application of the place of business safe harbor to homebuilders should be clarified. To establish the temporary use of a trailer or other facilities on the job site would not be a principal place of business provided by the service-recipient, the following language should be added at the end of Sec. (b)(2)(B)", or if the individual is provided temporary use of the facilities on the site where the work is performed." In addition, report language indicating

that work performed at a construction job site does not constitute a principal place of business should also be incuded.

3. *Investment of income fluctuation.*—To insure that workers on construction sites qualify for the tangible assets requirement, an additional provisions should be added to the provisions dealing with definitions and special rules. This addition would be Sec. 2(c)(5) "SPECIAL RULE FOR DETERMINING INVESTMENT OR INCOME FLUCTUATION.—For purposes of Subsection (b)(3) the individual shall be deemed to have a substantial investment in assets if the individual furnishes the asset or the assets customarily used in the performance of the service."

CONCLUSION

With the expiration of the moratorium on June 30, 1982, the prospects of retroactive reclassification of independent contractors as employees looms on the horizon. Such action would have devastating impact upon the homebuilding industry. Homebuilders do not keep records of the employees of subcontractors. While many homebuilders will probably be able to utilize the common law to demonstrate lack of control, the common law test has 20 elements. Reliance upon these tests is more difficult and uncertain, and increases the potential for needless tax audits and expense. NAHB urges that the common practice of subcontracting be clearly covered within any legislation which the Congress enacts to establish a safe harbor test for independent contractor.

STATEMENT OF DOW REICHLEY, FMS, PRESIDENT, AND NICK A. VERREOS, FMS, CHAIRMAN, FEDERAL AFFAIRS COMMITTEE, NATIONAL ASSOCIATION OF PROFESSIONAL INSURANCE AGENTS

The following position statement is submitted to the Subcommittee on Select Revenue Measures of the Committee on Ways and Means by the National Association of Professional Insurance Agents (PIA).

PIA is a national trade association representing more than 38,000 independent property and casualty insurance agents in all 50 States, the District of Columbia, Puerto Rico, the U.S. Virgin Islands and Canada.

We commend the Subcommittee's distinguished Chairman, The Honorable Fortney H. (Pete) Stark, for holding hearings on the controversial classification issues relating to independent contractors.

PIA's prime concern centers around the fact that the moratorium provisions of Section 530 of the Revenue Act of 1978 (P.L. 95-600), extended by Public Laws 96-167 and 96-541, will expire on June 30, 1982. This law provides interim temporary relief for individuals who have historically been treated as independent contractors for federal income, social security and unemployment taxes withholding purposes.

This issue has come to the fore over the last decade because of political pressures upon the Internal Revenue Service (IRS) to maximize their revenue collection efforts in an effort to reduce looming federal deficits. The IRS revised its classification criteria used to determine whether certain self-employed individuals would be classified as "independent contractors" or "employees" for purposes of collecting federal employment taxes. The IRS had been making this determination based on the common law test of who controls the work situation and a list of 20 common law factors adopted to determine whether an employer-employee relationship existed. It became evident that the IRS was intent on narrowing their interpretation of this criteria so that more and more of those traditionally classified as independent contractors could be taxed as employees. This approach had obvious revenue collection advantages for the IRS and was justified on allegations that independent contractors were not paying their fair share of employment taxes and that withholding would increase compliance. As the IRS expanded this re-classification effort, independent contractors began to complain to the Congress and the aforementioned statutory moratoriums were enacted.

A highly controversial IRS study, conducted in 1979, concluded that some independent contractors were involved in substantial levels of tax avoidance. Consequently, there is every reason to believe that if Public Law 96-541 is allowed to expire, the IRS appears ready to renew their efforts to re-classify many self-employed small businesspersons who provide services to others on a fee or commission basis.

Independent property and casualty insurance agents licensed pursuant to the insurance laws of the state(s) where they conduct business, produce for a number of different insurance companies. With their business organized in this manner they are able to tailor insurance coverage to meet the particular and often specialized needs of their clients while providing such coverage at the lowest competitive price. Agents are compensated for the services they provide by receiving a percentage of the premium due on the line(s) of insurance involved.

Independent insurance agents have been treated as independent contractors by the IRS for federal employment tax purposes for over 25 years under the common law test and applicable rules and regulations. The agents PIA represents pay their taxes as required by law and their record of voluntary compliance is excellent. PIA members are small businesspersons who do not want to experience the legal uncertainty and possible costly protracted litigation that may result if the IRS should arbitrarily decide after June 30th that they are to be re-classified as employees of the several insurance companies for which they produce.

This situation can and must be resolved prior to June 30, 1982 so that independent contractors can continue their business activities without fear of becoming the victim of unreasonable IRS administrative enforcement zeal.

PIA, therefore, endorses H.R. 6311, the Independent Contractor Tax Classification and Compliance Act or other legislation containing its classification criteria. We support the five requirements of the "safe harbor" test contained in Section 2(b) of the bill:

"(1) Control of hours worked." Agents control the aggregate number of hours they work and the scheduling thereof. Generally, this aspect of their business is under the agents exclusive control.

"(2) Place of business." The principal place of business where agents work is the insurance agency with which they are affiliated. Their independent agencies are not owned by an insurance company. Agents do not work at locations provided by the insurers for which they produce. Business not conducted at the agency office takes place at various prearranged convenient locations acceptable to both the agent and their client.

"(3) Investment or income fluctuation." Agents have a substantial investment in the assets of their agency in terms of office space and related equipment. Agents frequently own the building and land where their agency is located. There remuneration is directly related to the premium volume produced and fluctuates accordingly. More than 90 percent of their compensation is tied to sales and sales related output.

"(4) Written contract and notice of tax responsibilities." Agents enter into a negotiated written contract with each insurance company for which they produce which sets forth the commission rate at which they will be compensated for particular lines of insurance and related agency matters. Agents would have no difficulty agreeing to the bill's provisions requiring that their agency contracts contain provisions that agents would not be treated as employees for purposes of employment taxes, income tax withholding, certain employee benefit provisions, and providing written notice of the agents responsibilities for payment of federal self-employment and income taxes.

"(5) Filing of required returns." This provision does not apply to independent insurance agents. The responsibility for compliance with this subsection rests with the service-recipient which is an insurance company.

PIA members who are currently treated as independent contractors will experience no difficulty in complying with the safe harbor test.

They would also have no difficulty in meeting the alternative common law test for establishing independent contractor status contained in Section 2(d). This test is generally based on the degree of or right of control that the service recipient has over the service provider. The agent controls substantially all aspects of the conduct of his business in terms of time expended, location where the service is provided and investment in necessary equipment and location. The insurers for which an agent produces are primarily interested in the end result which is the execution of a contract of insurance and payment of the premium by the insured.

The classification provisions of H.R. 6311 are reasonable and do not appear to reclassify anyone as an independent contractor who is currently treated as an employee for federal employment tax purposes. It simply maintains the status quo. This bill should put the independent contractor/employee tax status controversy to rest and provide clear, concise and unmistakable policy and enforcement guidelines for the IRS.

PIA strongly urges the Subcommittee and the full Committee to act with all deliberate speed to mark-up and report the classification provisions of H.R. 6311.

PIA realizes that the June 30th expiration of the current moratorium contained in Public Law 96-541 is rapidly approaching and that there may not be sufficient time remaining for both Chambers to enact remedial legislation into law prior to the expiration date. Should this occur, PIA urges the Subcommittee to report another extension of the moratorium provisions of Section 530 of the Revenue Act of 1978.

NICOR DRILLING,
Tulsa, Okla., June 11, 1982.

Re Independent Contractor Bills.
JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

DEAR SIR: We support the Committee's efforts to clarify the status of independent contractors under the Internal Revenue Code. I request that this statement be included in the record of the June 11 hearing of the Subcommittee on Select Revenue Measures.

NICOR Drilling Company presently owns 79 drilling rigs and operates in 26 states within the United States. In the course of fabricating these oil rigs, NICOR Drilling Company contracts with drilling rig welders on an "as needed" basis. The welders are required to provide and maintain their own welding equipment and supplies. We pay them an hourly rate which covers both their labor and a return on their equipment. Many welders are incorporated; some own more than one rig and hire their own assistants; many work with more than one fabricator in any given year. As is the custom in the industry, we have always treated drilling rig welders as independent contractors.

We support H.R. 4971, introduced by Congressman Philip Crane, because it clearly provides that the rig welders would be independent contractors since they own and maintain their welding rigs.

The other proposed bills would all require the worker to control the scheduling of hours he worked. This worries us. We must manage the times and locations when and at which the welding is done in order to integrate welding with our other work, but the welders control the aggregate time they work. We supported S. 2369 because Senator Dole explained that drilling rig welders would, in most cases, satisfy the similar condition in that bill. We also understand that the Treasury Department suggested at the April 26 Senate hearing that who controls the hours worked may not be relevant to whether withholding taxes is appropriate. We agree and would support dropping or modifying the condition.

Sincerely,

WENDELL D. CLEAVER, *President.*

STATEMENT OF ROBERT L. PARKER, JR., PRESIDENT AND CHIEF OPERATING OFFICER, PARKER DRILLING CO.

Mr. Chairman and Members of the Committee: I greatly appreciate the opportunity to provide some input to the Committee with regards to H.R. 6311. This bill is designed to provide a four-step test for determining who is an independent contractor. In short, it is intended to provide a safe-harbor. As do most businessmen in this country, I heartily support your efforts.

Parker Drilling Company has long contracted with independent welding contractors and rig welders, to aid us in the construction of drilling rigs. For that reason we are intensely interested in this bill. These rig welders have always been treated as independent contractors by us and by the rig building industry. They operate under written contracts which require, among other things, the filing of IRS Form 1099's. Just as importantly, they have always considered themselves as independent businessmen, and don't want a change in that status.

According to the bill, if the contractors meet the four-point requirement, they are in the safe harbor and shall not be treated as an employee. These rig-welders clearly meet three of the requirements, but the scheduling requirement, not clear on its face, is even less clear under the so-called special rule at § 3508(C)(4). What appears to be an inadvertent non-sequitor could provide the basis for unnecessary and expensive litigation and could jeopardize their taditional status and inhibit growth in the rig-building industry. I am sure that no one in this room wants to see that happen.

New section 3508(4), beginning at page 7, line 22 of the bill and continuing over to page 8, line 2, creates our problem. That subsection is designed to provide further definition to § 3508(b)(1), which requires the individual, in order to be considered an independent contractor, to control, ". . . the aggregate number of hours worked and substantially all of the scheduling of the hours worked."

Such a scheduling requirement would disqualify otherwise qualified welding contractors. These small entrepreneurs, who invest substantial sums in their businesses, have no intention of becoming employees of Parker Drilling Co. or any other concern. They have informed our people that if they are declared employees, Parker will have to look elsewhere to find people to provide this critical service.

It is economically unsound for Parker to invest in hundreds of welding machine outfits to meet a peak need of 700 welders, when they may need only 50 one year later. Additionally, rather than travel with their rigs to new jobs, they would be forced to file for unemployment, accepting taxes instead of paying taxes. Traditionally, the rig building business has been unbelievably cyclical.

Welders operating under written contract and issued 1099's, easily meeting the investment and place-of-business tests, would be considered as independent contractors under this bill only if they also meet the scheduling test. However, in order to assure that just such people were included in this "safe-harbor," the Special Rule was added to clarify things. Subsections (A), (B) and (D) are perfectly reasonable, meet legitimate needs, and do clarify critical points. But subsection (C), apparently through inadvertence, creates an incredible situation which could line the pockets of a few tax lawyers, but won't help the contractors.

Subsection (C) provides that "an individual shall not be treated as not controlling any scheduling of hours worked merely because such individual's control is limited as a result of—

"(C) the coordination of the performance of service with the performance of other services but *only is such coordination is done by a person other than the service recipient or a related person,* or . . ." (Emphasis supplied.)

The underlined portion presents a problem, which appears to be clearly insurmountable for any person who does business in the owner-contractor-subcontractor method. Anyone who builds houses, buildings, or drilling rigs will inherit a whole new class of employees who have traditionally been considered subcontractors.

Let me give you an example: If you hire someone to paint your dining room, you don't want them to paint it after the carpet is laid, but before. However, as the bill now stands, if you schedule the painting before the carpet laying, you will preclude your painter from qualifying under H.R. 6311 as an independent contractor because the coordination is effected by the service recipient. Instead, in order to meet the requirements of the bill, you will have to get someone else to do the scheduling to coordinate the performance of the service. Just how logical is that?

Surely, no one intended this result. The language in subsection (C) has probably been taken out of context from our fact sheet we had earlier supplied which intended to use the bulk of the emphasized language above as a separate subsection (E): "Any scheduling effected by a person other than the service recipient or a related person." The incorporation of our item (E) into part of (C) as above may well create more problems than the rest of this well-intended bill solves.

I assume no one opposes the proposition that coordination of the service with other services, regardless of by whom, is a construction necessity which should have no bearing on the independence of any contractor. You would schedule that carpet layer after the painter, yet neither the carpet layer nor the painter would or should be your employee. We have to schedule the welders to work after the steel arrives, not before, but they aren't our employees either.

This problem can be easily solved by placing a comma at the end of line 23, page 7, adding the word "or" and deleting line 24 and lines 1 and 2 of page 8. Finally, a comma could replace the period in line 6, page 8, the word "or" added and a new subsection (E) inserted which reads:

"(E) Any scheduling effected by any person other than the service recipient or a related person. . . ."

Such a change will create the reasonable and safe harbor necessary to avoid creating a new class of employees while insuring that income earned by these entrepreneurs is reported and taxed. That, of course, is a goal we all share.

Thank you very much for your kind cooperation and consideration in this matter.

Penrod, George & Co.,
Napoleon, Ohio, June 4, 1982.

John J. Salmon,
Chief Counsel, Committee on Ways and Means, House of Representatives, Longworth House Office Building, Washington, D.C.

Dear Mr. Salmon: This is in response to the Subcommittee on Select Revenue Measures request for comments concerning H.R. 6055, the Subchapter S Revision Act of '82.

Our firm provides tax services for several hundred private businesses. We are, therefore, in a position to express informed opinions on the issues enumerated below:

Certain Individual Items of Income and Loss.—We believe there are few compelling reasons to change from the present rules, with one exception. The exception is that contributions to qualified employee retirement plan trusts should be subject to the same limitations as regular corporations with respect to stockholder-employees. The expressed policy intent of congress has been to encourage savings for retirement. Under present law, stockholder-employees of Subchapter S corporations are at a disadvantage solely because of the election and not because of any change in the form of business. In all legal respects, the employee group does not differ from a regular corporation. It follows, therefore, that retirement benefit contribution deductions should have the same limitations under Subchapter S as for a regular corporation.

Taxation Upon Election Under Subchapter S.—We believe the present provisions are adequate. The non-taxability of making the election causes no significant loss of tax revenue for the government, is an uncomplicated procedure, and should be continued.

One Class of Stock.—We believe that the present limitation serves no significant benefit to the government. It does, however, impair flexibility in equity capital financing of a Subchapter S Corporation. For this and other debt-equity considerations, more than one class of stock should be permitted.

Revocation of Election.—We believe the same time limitation should be used for both making and revoking the election. Accordingly, a revocation should be timely if made within seventy-five (75) days of the beginning of the taxable year to be revoked. Experience reveals that revocations arise from financial requirements and changes in stockholders as well as from tax considerations. These events usually occur as of the end of a fiscal year. The present thirty (30) day limitation imposes unreasonable haste in arranging stockholder meetings and drafting legal instruments for decisions having significant economic impact on both the Subchapter S Corporation and its stockholders. We do not believe that extending the present time limit would significantly affect tax revenue for the government.

We also would like to remind the Committee of the complexities already involved in the operation of Subchapter S. Changes adding to that complexity should be vigorously resisted. Additional costs can only reduce profits which, in turn, reduces tax revenue for the government.

Sincerely,

ROBERT R. GEORGE,
CPA, Director of Operations.

RECORDING INDUSTRY ASSOCIATION OF AMERICA, INC.,
New York, N.Y., June 14, 1982.

Hon. FORTNEY H. STARK,
Chairman, Subcommittee on Select Revenue Measures, Committee on Ways and Means, House of Representatives, Longworth Building, Washington, D.C.

DEAR MR. CHAIRMAN: In response to your press release dated May 13, 1982 announcing a public hearing on issues relating to the classification of workers for federal employment tax purposes, the Recording Industry Association of America, Inc. ("RIAA") hereby submits its comments for inclusion in the Subcommittee's official hearing record.

RIAA, representing the interests of the U.S. sound recording industry, supports the enactment of safe harbor legislation to confirm the classification of self-supervising workers, including recording artists, as independent contractors for federal employment tax purposes. The facts concerning the independent status of recording artists are summarized below.

The production of sound recordings represents merely one aspect of the various income producing activities carried on by a recording artist. In addition to the royalties earned from the sale of phono-records, recording artists typically tour, giving personal performances in nightclubs, theaters and concert halls, and appear on television and in motion pictures. The earnings derived from each of these activities depend upon the use of material developed and perfected during uncounted hours of practice and preparation for performance. The typical recording artist enjoys a high degree of independence and sells his services through personal appearances and various kinds of media. The artist himself exercises ultimate control over the details of his performance, and, for this reason, performing artists have traditionally been classified as independent contractors under the common law test.

The nature of the relationship between a recording artist and a recording company may be illustrated by the following example: A recording artist enters into a contract with a recording company providing for the recording, manufacture, release, promotion and distribution of sound recordings. The recordings are to be made in the company's recording studio in New York at a time agreed to in light of the projected release date of the recordings. The recording artist has earnings from various sources, including nightclub and theater performances. The earnings derived by the artist from each of his activities depends upon the use of material developed and perfected by him on his own time. The hours spent in the recording studio are a minor portion of the artists's total hours worked, including practice and preparation time. The recording company notifies the recording artist that a studio is available during the last ten days of May, 1982, a date which is consistent with the projected release date agreed to by the artist and the recording company. The artist utilizes the studio during this ten day period and a master tape is prepared for reproduction and eventual release to the public. Under the contract between the artist and the studio, the artist will be compensated solely on the basis of royalties derived from the sale of tapes and records. The company charges the artist a fee for the use of its studio payable out of the artist's royalties. Under the contract, studio rental charges are not collectible to the extent the artist's royalties are insufficient to cover such charges.

Under the facts of the above example, the recording artist should be classified as an independent contractor and not as an employee of the recording company, without regard to which party has ultimate control over the scheduling of studio time. In some cases, the time spent in the recording studio is scheduled to a significant extent by the recording company. In other cases, the artist books his own studio hours or substantially controls the recording schedule by way of control of the release schedule for the recordings. In any case, the time in the studio is only the culmination of a great deal of work scheduled at times governred by the artist's own discretion. For this reason, there should be no question that a performing artist enjoys a large measure of control over the hours worked and the scheduling of those hours.

Similarly, the fact that the recording ultimately takes place in a "place of business" or studio owned by the company or provided at the company's expense (subject to reimbursement) should not affect the classification of the artist as an independent contractor. Hundreds of hours of practice and preparation, at locations determined by the artist, necessarily precede the utilization of a recording studio. Under these circumstances, the fact that the studio is provided by the company is of little significance.

The above suggestions concerning the classification of recording artists are equally applicable to other performing artists. The violinist who plays in Carnegie Hall, as well as the nightclub performer, should be considered an independent contractor for similar reasons.

The above information concerning recording artists does not apply to "sidemen" paid on an hourly basis to accompany an artist. Sidemen are subject to control by the studio, and by the recording artist, to a significant extent. For this reason, sidemen are currently treated as employees by recording companies for income tax withholding and FICA purposes.

We appreciate your consideration of the above facts concerning the classification of recording artists as independent contractors.

Respectfully submitted.

STANLEY M. GORTIKOV, *President.*

STATEMENT OF THE RETAIL FLOORCOVERING INSTITUTE

The Retail Floorcovering Institute (RFI) is a national trade association headquartered in Chicago, Illinois, representing more than 4,500 retail carpet outlets. RFI member companies account for approximately 54 percent of all floorcovering products sold at retail in the United States.

Our association strongly endorses H.R. 6311, introduced by Rep. Richard Gephardt of Missouri with bipartisan support, as a balanced bill which will effectively resolve the long-standing tax controversy involving independent contractors. If H.R. 6311 is enacted, we believe the taxpayers will have the proper guideposts and the kind of certainty about their tax obligations that have been sorely missed in the past.

We very much appreciate this opportunity to submit this statement to the Subcommittee, and we hope that our views on this issue assist the members of the Subcommittee in resolving the controversy surrounding the tax status of independent contractors. Since the Internal Revenue Service instituted its campaign to challenge the status of independent contractors, our industry's use of installers has been the target of countless IRS audits which have resulted in costly and lengthy battles and untold aggravation for floorcovering retailers. While we certainly appreciate the moratorium prohibiting IRS reclassification audits that Congress approved in 1978, and later extended, we are hopeful that you will approve H.R. 6311, which, in our opinion, will equitably resolve the issues in the independent contractor tax controversy.

HOW IS THE INDEPENDENT CONTRACTOR USED IN THE RETAIL FLOORCOVERING INDUSTRY?

The Retail Floorcovering Institute in a poll of its membership found that 70 percent of our members use independent contractors for installation work.

To explain how the floorcovering industry utilizes independent contractors, an RFI member, owner of a five-store chain operating in the Midwest, provides the following narrative:

"The independent contractors that we engage do carpet and tile installation of products purchased from our showrooms. We use both independent contractors and our own employees for this work. I have often been asked why we could choose an independent contractor/installer over an employee/installer. My answer is that we simply have fewer problems with our independent contractors. They are much more conscientious about their work, and it is a totally different relationship than we have with our employees.

"The independent contractors that we deal with come to our firm looking for work. Obviously, we make an effort to determine whether an individual can perform to our standards, and we will generally check some of his past work. Once we are satisfied that he can do his job, we will give him the opportunity to bid for the job.

"After we decide to enter a business relationship with his firm, we use a contract which clearly specifies that the independent contractor is not an 'employee' of our company and that he is fully responsible for payment of all applicable federal, state, or local taxes.

"The independent contractors will normally request as many workdays each week as they wish. We will try to provide them with jobs to install on the days they have requested. A good many will want to work every day. Some may then hire additional employees of their own, or split up and form two different installation companies. Some are very new at this business, and they want all the work they can get and don't care to seek out other business. But, it is very important to understand that just because an installer wants to do 100 percent of his business with my firm (and, frankly, we do have independent contractors who work predominantly for us), that does not make him any less an independent businessman than someone who might want to work 10 percent for me and 10 percent for nine other firms.

"I would further emphasize to the Subcommittee members that it is very important for them to understand that when customers have made a purchase, we try to accommodate their schedules and set the time for installation accordingly. For example, if the purchase is made on a Saturday, the customer might request the installation work on the following Tuesday. We do everything in our power to oblige the customer's schedule. It is important to note that the customer, in most cases, establishes the time for installation, and not the retailer. I would hope that it is clear that our scheduling of the installer's individual jobs is done to accommodate the customer and is not a factor indicating control over the independent contractor/installer."

H.R. 6311, "THE INDEPENDENT CONTRACTOR TAX CLASSIFICATION AND COMPLIANCE ACT OF 1982"

We believe that the "Safe Harbor Test" contained in H.R. 6311 will be the primary basis upon which members of this industry will attempt to qualify installers as independent contractors. Given the problems that industry members have had with inconsistent IRS audits, we seriously doubt that many floorcovering retailers will resort to the 20 requirements in the "common law test" employed by the IRS.

We would like to discuss the elements of the "Safe Harbor Test" in H.R. 6311 and examine the impact that they may have on industry members who will seek to qualify installers as independent contractors:

Section 2.(b)(1) *Control of Hours Worked.*—The individual installer does control the aggregate number of hours that he works and, substantially, all of the scheduling of the hours worked. Of course, it is the customer who ultimately determines the scheduling, and to the extent that an accommodation is made, the legislative history should be clear that such scheduling of the hours worked by the individual who provides a service would not fall outside the requirement of Section 2.(b)(1).

Section 2.(b)(2) *Place of Business.*—Our industry would have no difficulty complying with this section.

Section 2.(b)(3) *Investment or Income Fluctuation.*—In the floorcovering industry, installers will have an investment in tools and supplies necessary to perform their trade. We trust that this type of investment would be considered "substantial." Clearly, an individual installer risks income fluctuation, and his remuneration will be based on the number of jobs that he is willing to undertake, as well as the size of installations.

Section 2.(b)(4) *Written Contract and Notice of Tax Responsibility.*—Our industry association believes that a written contract between our member firms and installers would be appropriate, and we have no hesitancy to spell out in that contract the fact that the individual installer will not be treated as an employee for the purposes of the Federal Insurance Contribution Act, the Social Security Act, the Federal Unemployment Tax Act, and federal and state income tax withholding. Further, we agree that the individual should be reminded in this contract of his obligation to pay self-employment and federal income taxes.

Section 2.(B)(5) *Filing of Required Returns.*—We believe it is proper that our members be obligated to file 1099 (NEC) returns, and we commend Rep. Gephardt for proposing that informational reporting requirements be subject to a more stringent penalty for failure to comply than is presently the case. Because we, as an industry, are very much concerned with the allegations of noncompliance, we believe it is incumbent upon the Internal Revenue Service to match properly the 1099 (NEC) returns of the businesses with the income tax returns and social security tax payment of individual taxpayers who perform services as independent contractors. Accordingly, RFI also endorses the Tax Compliance Act of 1982 (H.R.6300), introduced by Chairman Rostenkowski.

RFI RECOMMENDATIONS

The Retail Floorcovering Institute believes that the Gephardt independent contractor bill, together with the Tax Compliance Act, would accomplish the objective of assuring that the tax dollars owed to the federal government by independent contractors will be paid. The congress is contending with the difficult task of narrowing projected budget deficits, and the members of RFI have no sympathy for those citizens who contribute to the budgetary dilemma by not paying their "fair share" of taxes.

Resolution of the controversy surrounding the tax status of independent contractors has been unnecessarily burdened for years by special interests seeking to expand the definition of an independent contractor to suit their particular needs. The Retail Floorcovering Institute believes that H.R. 6311, if enacted, equitably shares the responsibility of reporting compensation paid to independent contractors and assuring that taxes due are, in fact, paid.

We urge the Subcommittee and full Committee on Ways and Means to report H.R. 6311 without delay.

Statement on Behalf of Spectrum Emergency Care, Inc., Submitted by Lewis, Rice, Tucker, Allen & Chubb

MEMORANDUM REGARDING PROPOSED INDEPENDENT CONTRACTOR LEGISLATION AND INCLUSION OF EMERGENCY ROOM PHYSICIANS IN THE PROPOSED SAFE HARBOR RULES

This memorandum discusses the status of emergency room physicians as independent contractors, the proposed independent contractor legislation, and the need for safe harbor legislation protecting their status. Attached to this memorandum is proposed safe harbor legislation specifically addressing the emergency room physician situation and suggested committee report language with respect to the "no inference" provision in the existing proposed legislation. While this memorandum refers to certain cases and rulings, it is not intended to be a legal analysis.

I. General summary of emergency room practice

Emergency medicine is a recognized medical specialty that has been developing during the past ten years. Many hospitals are unable to staff their emergency room facilities with qualified emergency room physicians, and, therefore, if these hospitals are to be full-service hospitals, it is advantageous for them to contract for emergency room coverage with outside physicians. This coverage may be for weekends, night shifts (6 p.m. to 6 a.m.), and sometimes on a full 24-hour basis. This specialized practice is particularly beneficial to rural areas that many times are otherwise unable to obtain qualified emergency room coverage.

Our client, Spectrum Emergency Care, Inc. ("Spectrum"), is one of a number of organizations that contract with hospitals to provide them with physicians for emergency room coverage. Generally, these hospitals are Section 501(c)(3) organizations, although some are for profit (5 percent–10 percent). Spectrum services approximately 250 hospitals in 33 states. In many instances, the hospital's cost of obtaining emergency room coverage through Spectrum, including stand-by costs, is reimbursable through Medicare. There are approximately 5,300 short-term general hospitals with emergency rooms in the country of which over 800 use groups like Spectrum. Spectrum has contract arrangements with approximately 2,000 physicians. Spectrum annually serves in excess of one million patients and provides approximately 1.3 million hours of physician coverage, approximately 75 percent of which is in non-urban areas.

After a contract with a hospital is obtained, Spectrum will contract with qualified emergency room physicians to provide the hospital with coverage. Virtually all these physicians (approximately 90 percent) have other medical practices.

Physician contracts.—In contracting with Spectrum, the emergency room physicians are free to choose and change the number of hours they want to work and what periods of time they want to work within the times specified in Spectrum's contract with the hospital. The physicians are also free to subcontract with other qualified physicians to substitute for them. Emergency room physicians are usually paid a fee on an hourly basis because the nature of emergency room facilities rests upon having qualified physicians available, rather than the number of patients seen or the amount of billings.

The contracting physicians are not eligible for the hospital fringe benefits generally accorded regular hospital employees; nor are these physicians provided the fringe benefits generally available to Spectrum employees. These physicians as a group are named as additional insureds under Spectrum's general malpractice insurance coverage. This method of insurance coverage is utilized because of the cost savings due to group coverage over individual coverage of each contracting physician. Naming the physicians as a group as additional insureds under Spectrum's general malpractice insurance policy is at no additional cost to either Spectrum or the individual physicians contracting with Spectrum. Many of these physicians (approximately 95 percent) are also covered under other policies of malpractice insurance.

The contracting emergency room physician, like most physicians, other than certain company doctors and certain resident hospital physicians, has been traditionally viewed as an independent contractor by the contracting hospital, the contracting physician and Spectrum.

II. Review of law

Current state of the law.—Under current statutory law, there are no clear guidelines as to whether emergency room physicians are independent contractors or employees and if they were employees, whether they would be employees of groups like Spectrum or of the contracting hospital. There is no case law or published revenue ruling determining whether an emergency room physician is an employee or independent contractor. As a group, the practicing emergency room physicians have traditionally viewed themselves as independent contractors because they view this practice as part of their general practice and receive none of the benefits normally accorded hospital employees.

Treasury regulations.—Under existing law, the basis for determining whether a particular worker is an employee or independent contractor is determined under the common law test of control. Under that test, emergency room plysicians have generally viewed themselves as independent contractor because they control their work. We have attached as Exhibit A a review of the twenty common law factors customarily employed by the Internal Revenue Service.

This conclusion is also in line with Treas. Reg. § 31.3401(c)-1(C) which provides that: "Generally, physicians, lawyers, dentists, veterinarians, contractors, subcontractors, public stenographers, auctioneers, and others who follow an independent trade, business, or profession, in which they offer their services to the public, are not employees."

Until recently, it was believed that the Internal Revenue Service also agreed that emergency room physicians were independent contractors.

Cases and rulings.—There are no cases or published rulings establishing whether emergency room physicians should be treated as employees or independent contractors. However, there are cases and published rulings which tend to lend support to the emergency room physician's status as an independent contractor. See, for example, *Azad* v. *United States,* 388 F.2d 74 (8th Cir. 1968) and Rev. Rul. 66-274, 1966-2 C.B. 446.

In Rev. Rul. 72-203, 1972-1 C.B. 324, the Internal Revenue Service set forth the following four factors for determining whether a physician should be classified as an independent contractor or as an employee: (1) the degree to which the physician has become integrated into the operating organization; (2) the substantial nature, regularity, and continuity of the physician's work for the firm or person involved; (3) the authority reserved by the person or firm to require compliance with its general policies; and (4) the degree to which the physician has been accorded the rights and privileges generally established for the firm's employees. We believe that under these guidelines the emergency room physician should be classified as an independent contractor. It is important to observe that in the above ruling, no special emphasis was placed on the form of compensation.

Notwithstanding the general view that emergency room physicians should be treated as independent contractors, in a private letter ruling dated October 27, 1978, Letter Rul. 7904109, the Internal Revenue Service concluded (we believe erroneously) that certain physicians working under circumstances somewhat similar to the Spectrum contractual arrangement were employees, not independent contractors.

However, both before and after the issuance of the above private letter ruling, and notwithstanding its existence, the Internal Revenue Service, to the best of our knowlege, has on audit consistently permitted emergency room physicians to be treated as independent contractors. This is due in part to Internal Revenue Service examining agents finding a "reasonable basis" for independent contractor status under the Revenue Act of 1978 (Section 530, P.L. 95-600, as amended by P.L. 96-167 and P.L. 96-541).

III. Application of principal factors

In support of independent contractor treatment for emergency room physicians (in addition to the discussion of the twenty common law factors noted above) are the following factors: each emergency room physician has a professional degree; most physicians are traditionally treated as independent contractors; the emergency room physician controls the way in which he works; he is not well integrated with the hospital or Spectrum; he does not have rights, privileges or fringe benefits or either Spectrum or the hospital; he is free to select his own hours; he has a nonexclusive arrangement with Spectrum; and he is free to contract with other hospitals and organizations like Spectrum, and to have his own private practice.

On the other hand, the emergency room physician is usually paid a fee on an hourly basis, he does his emergency room work on the hospital premises, and in some cases agrees by contract to work a set number of hours.

On balance, while the application of these factors supports independent contractor status, this conclusion is not free from question because of the ambiguities under present law. Furthermore, if for any reason the physicians were treated as employees, there is no certainty whether they would be treated as employees of Spectrum or employees of the hospitals in which they provide emergency room services.

IV. Disadvantages of employee status

Insuring that emergency room physicians will continue to be treated as independent contractors will help to prevent hospital and other medical care costs from further escalation, as would be the case if the Internal Revenue Service were ultimately successful in determining that these individuals were employees and not independent contractors. For example, if these individuals were treated as employees, there would be additional expenses, which expenses would include additional employment taxes, additional malpractice coverage, and fringe benefit coverage normally provided employees, including medical, life insurance, and pension and profit sharing benefits that may be required to be paid on these individuals' behalf. These additional expenses would substantially increase the cost to the hospitals for the emergency room coverage provided by groups like Spectrum, which cost ultimately would be borne by the hospital patients, and to an extent by both Federal and state governments (e.g., Medicare, Medicaid, other government medical insurance costs).

Proposed safe harbor legislation

We believe that many of the groups of workers covered by the proposed safe harbor legislation do not fare as well as the emergency room physician under the twenty common law tests. We understand that the proposed safe harbor legislation was drafted after consultation with a coalition of industry groups seeking protection. Hospital based physicians were not a part of the coalition and it is clear that the legislation was not directed to providing protection for them. As we read the proposed legislation, it selects out of the twenty common law factors only four of those factors which happen to benefit the coalition group to the exclusion of the other factors.

We have no problem with granting safe harbor protection to the industry groups that meet those four selected factors. However, to elevate one of those factors—the one prohibiting payment on an hourly basis—to a supremacy status that effectively constitutes a roadblock to any professional who otherwise would qualify as an independent contractor is to put too much emphasis on one of the twenty common law factors. This is particularly true since professionals by their nature are frequently paid a fee on an hourly basis.

In our opinion the four selected factors are of no greater significance than many of the other sixteen factors—the four factors just happen to satisfy the desires of the coalition that participated in the drafting of this legislation. Actually, one of the most important factors, the one that answers the question: "Are the services performed by the individual integrated into the business operations?" has not been picked for elevation to supremancy status because many individuals working in industries that are part of the coalition do not meet that test because of the very nature of their industries. This important test for independent contractor status is one which most hospital based physicians would satisfy and which indicates to us that the hospital based physicians should be protected in any safe harbor legislation.

VI. Conclusion

We strongly believe that because of the current uncertainties in the treatment of emergency room physicians, that this is a situation that should be addressed by any proposed safe harbor legislation. Based upon the above, it should be very clear that the emergency room physician is an independent contractor and any safe harbor legislation should include this group of workers. We have attached hereto suggested legislation that would provide a safe harbor for those hospital physicians who have historically been considered independent contractors and not employees.

We have also attached proposed committee report language with regard to the "no inference" provision in the proposed legislation if the safe harbor requirements are not satisfied.

Statistical studies show that these physicians are within that group of taxpayers who consistently pay their taxes and are not within that group of taxpayers who have used independent contractor status as a means to avoid the tax reporting requirements.

Because of the unique nature of the emergency room practice, it does not fit within the proposals made under the proposed legislation. Quality emergency room medical care requires the continuous availability of emergency room physicians and continuity in scheduling. These factors should not adversely affect the emergency room physician's status as an independent contractor. Special limiting legislation is therefore required for these professionals.

Furthermore, while emergency room physicians who are not regular employees of the hospital have been traditionally treated as independent contractors, there is concern that the Internal Revenue Service may take a much harsher stance with respect to those individuals who do not fall within the safe harbor requirements of the legislation, notwithstanding contrary language in the proposed bills (see attached proposed committee report language noted above with respect to "no inference" provision). If the safe harbor legislation becomes law in the present form, it is conceivable that emergency room physicians will then be required to spend substantial time and expense justifying their status before the Internal Revenue Service. Since it is the intent of the safe harbor legislation to avoid conflict situations where possible, provision should be specifically made in the legislation for emergency room physicians. Of all the groups of workers, the emergency room physicians. Of all the groups of workers, the emergency room physician is perhaps one of the best suited for safe harbor legislation. We respectfully suggest that any safe harbor legislation specifically address the emergency room physician.

Exhibit A.—Application of Twenty Common Law Factors Relating to Employee/Independent Contractor Status of Emergency Room Physicians

The application of the twenty common law factors that the Internal Revenue Service generally considers in determining whether an employer-employee relationship exists (see Joint Committee on Taxation staff pamphlet on S. 2369, Independent Contractors' Tax Classification and Compliance Bill of 1982 I.R. Manual, Ch. 4600, Employment Tax Procedures, Exhibit 4640-1), as applied to the emergency room physician, reveals the following:

1. Is the individual providing services required to comply with instructions concerning when, where, and how to work is to be done? The emergency room physician generally determines when, where, and how his work is to be performed; he selects the hours of coverage to be provided within the time frames of the hospital's needs; he selects which hospitals he is willing to provide these services for; and he, as all physicians, detemines what work is to be done and how the work is to be performed.

2. Is the individual provided with training to enable him or her to perform a job in a particular manner or method? The emergency room physician is not provided any initial or ongoing training from the hospital; rather he generally obtains his training on his own time and at his own expense.

3. Are the services performed by the individual integrated into the business operations? The emergency room physician is not integrated into the hospital business or administrative operations and is not provided any of the benefits provided hospital employees generally.

4. Must the services be rendered personally? In many situations the emergency room physician is not required to render his service personally; rather he may hire other qualified physicians to replace him at his own direction. The services therefore need not be rendered personally.

5. Does the business hire, supervise or pay assistants to help the individual performing services under contract? The emergency room physician, like any private physician treating patients in a hospital, has the use of nurses and other staff at the hospital to assist him in performing his services. However, none of the assistants are hired to assist the particular physician.

6. Is the relationship between the individual and the person for whom he or she performs services a continuing relationship? A continuing relationship with the hospital is not a prerequisite to emergency room practice; often an emergency room physician will have a practice or professional relationship totally separate from the emergency room. Subject to the needs of the hospital, the emergency room physician selects the hours he is willing to provide services to the hospital as an emergency room physician.

8. Is the individual required to devote full time to the person for whom he or she performs services? No.

9. Does the individual perform work on another's business premises? Yes.

10. Who directs the order or sequence in which the work must be done? The emergency room physician determines the order or sequence in which the work must be done.

11. Are regular oral or written reports required? No oral or written reports are required.

12. What is the method of payment—hourly, weekly, commission or by the job? Usually either an hourly fee based on coverage provided or a fee based on revenue generated, depending upon the volume of patients using the emergency room and the emergency room's need for stand-by coverage by an emergency room physician.

13. Are business or traveling expenses reimbursed? Generally no.

14. Who furnishes tools and materials necessary for the provision of services? Facilities furnished by the hospital; personal medical equipment may be provided by the emergency room physician.

15. Does the individual performing services have a significant investment in facilities used to perform services? No.

16. Can the individual providing services realize both a profit or a loss? Generally no.

17. Can the individual providing service work for a number of firms at the same time? Yes.

18. Does the individual make his or her services available to the general public? Generally yes.

19. Is the individual providing services subject to dismissal for reasons other than non-performance of contract specifications? Generally no.

20. Can the individual providing services terminate his or her relationship at any time without incurring a liability for failure to complete a job? Generally not.

The application of the above common law tests demonstrates that the emergency room physician should be treated as an independent contractor. The answers to the 20 questions point to employee status in only 4 cases with respect to the emergency room physician and in the other 16 cases point to independent contractor status. While the answers to 4 of the questions (questions 9, 12, 15 and 16) point to employee status, that is principally because of the unique nature of the medical profession and the hospital system in the United States. The following page tabulates the above twenty factors in chart form.

CHART OF COMMON LAW TESTS FOR EMPLOYEE/INDEPENDENT CONTRACTOR STATUS

Question[1]	Emergency room physician	
	Employee	Independent contractor
1		X
2		X
3		X
4		X
5		X
6		X
7		X
8		X
9	X	
10		X
11		X
12	X	
13		X
14		X
15	X	
16	X	
17		X
18		X
19		X
20		X
Total	4	16

[1] The 20 questions correspond numerically with the 20 questions set forth by the Joint Committee on Taxation in its staff pamphlet on S. 2369 and as listed on the preceding pages of this exhibit A.

A Bill to Amend the Internal Revenue Code of 1954 to Provide That Certain Hospital Physicians May Be Treated as Independent Contractors for Purposes of the Employment Taxes

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. Chapter 25 (relating to general provisions relating to employment taxes) is amended by adding at the end thereof the following new section:

Sec. 3509. Certain individuals providing medical services in hospitals.

"(a) *General rule.*—For purposes of this subtitle, if the requirements of subsection (b) are satisfied, an individual rendering medical services in a hospital shall not be treated as an employee of either the hospital or of any person (other than a corporation in which the individual owns, directly or indirectly, within the meaning of section 318(a), 10 percent or more of the total combined voting power of all classes of stock of such corporation) who arranges for the individual to render the medical services in the hospital.

"(b) *Requirements.*—The requirements referred to in subsection (a) are as follows:
(1) The individual providing medical services in the hospital is a licensd physician, entitled to practice medicine in the state where the hospital is located; and

(2) The hospital, or the person arranging for the individual to render the medical services in the hospital, if any, and the individual agree in writing, before the later of (A) the date the services are to be first rendered or (B) [60 days after the date of enactment of this Act], that the individual is to be treated as an independent con-

tractor, and not an employee, with respect to the hospital and the person arranging for the individual to render the medical services in the hospital, if any.

"(c) *Effect on Subtitle A.*—If all the requirements of subsection (b) are met with respect to service performed by an individual, such individual shall not be treated as an employee of the hospital or of the person placing the individual in the hospital, if any, for purposes of applying any provision of subtitle A."

SEC. 2. The amendments made by this Act shall take effect with respect to payments made after June 30, 1982.

SUGGESTED COMMITTEE REPORT LANGUAGE WITH RESPECT TO "NO INFERENCE" PROVISION OF PROPOSED INDEPENDENT CONTRACTOR TAX LEGISLATION

No inference provision where safe harbor is not satisfied.—With respect to the no inference provision, it is very important that the Congress emphasize that the Internal Revenue Service is not being given carte blanche to classify workers as employees when the safe harbor is not satisfied. It is clear that the proposed legislation is not directed to all types of independent contractors, but only to certain types, e.g., particularly sales people, truckers, real estate agents and insurance agents. Specifically not addressed are the various professional groups. This should be emphasized in the report. For example, committee report language along the lines of the following would be desirable:

"The committee bill is designed to cover only a specified class of independent contractors, particularly those who control the hours worked and who, in addition, either have a substantial investment in tangible assets or risk income fluctuation because their remuneration is not directly related to the number of hours worked. Accordingly, the bill preserves the common law standard as an alternative test for classifying workers and includes a no inference clause to assure that no presumption of employer-employee status is created with regard to any worker who does not satisfy the safe harbor test.

"In particular, the bill is not intended to exclude all professionals who are paid a fee on an hourly basis from independent contractor status. For example, certain types of independent contractors, such as certain types of physicians and lawyers are often paid a fee based on the number of hours worked and, therefore, will not satisfy the safe harbor test. This is particularly true in the case of the hospital based physician who is paid for his coverage and thus must be paid on an hourly basis. The committee intends that these types of individuals will continue to be treated as independent contractors under the common law principles without regard to this legislation."

TAX EXECUTIVES INSTITUTE, INC.,
Arlington, Va., March 19, 1982.

Re Public hearings on legislative proposals relating to the classification for workers for Federal employment tax purposes.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: Tax Executives Institutes, Inc. ("TEI") is an organization with approximately 3,800 individual members representing 1,800 of the largest corporations in North America. Membership in TEI consists of persons employed by corporations who are charged with the administration of the tax affairs of their employers in and executive, administrative, or managerial capacity. Members in TEI come from practically all, if not all, of the major industries in the country with many different independent contractors in many different independent occupations.

On July 17, 1979, a contingency of official representatives of TEI appeared before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means and on September 17, 1979, a contingency appeared before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee to testify, present written statements and answer any questions which any respective Congressman or Senator might have on the proper tax treatment of employees and independent contractors. Attached is a copy of each of the oral and written submissions.

We have reviewed our prior written testimony and find that it continues to represent TEI's position on this important subject and ask that it be carefully reviewed and considered when the Committee proceeds in this area. Regardless of any legislation which might be approved, we remain unalterably opposed to any provision which might require any withholding on any payments made to independent contractors.

If the Committee or any individual member wishes additional comments, testimony, or other information we will be more than happy to reply in person or in writing to any questions you may have.

Respectfully submitted.

THOMAS P. MALETTA, *President.*

[Enclosed with the above letter were statements previously printed as follows: Statement of William J. Fait in "Independent Contractors," Committee on Ways and Means, serial 96-32, pp. 500-12; and statement of James M. Bodfish in "Miscellaneous Tax Bills II," Committee on Finance, serial 96-40, pp. 122-36, 560-62.]

STATEMENT OF CHARLES DUNHAM, PRESIDENT, VACUUM DEALERS TRADE ASSOCIATION

Mr. Chairman, the Vacuum Dealers Trade Association is honored to have this opportunity to present its views before your committee. VDTA serves 15,000 vacuum dealers throughout the Nation, a great number of whom are "independent contractors" for federal income tax purposes. We have numerous concerns about the enactment of legislation in this area, the urgency of which has been created by the June 30 expiration date for the moratorium on IRS rulemaking.

First, we believe that the committee should carefully evaluate the rationale behind the IRS rule: that so many of the nation's independent contractors are tax cheats that we should either: (1) ignore his independence and create the fiction that he is employed; or (2) impose an avalanche of paperwork and reporting to keep track of his income. The IRS' 1979 study on compliance has been thoroughly discredited—our people are paying their taxes and do not deserve to have their integrity questioned by the IRS. We urge you to take careful note of the Direct Sellers Association study and ask yourself whether this situation deserves the regulatory overkill that has been prescribed by the IRS.

We are concerned then that, despite assurances from Mr. Egger that the IRS will "go slow" with its rulemaking, independent contractors within VDTA are extremely vulnerable to extremely vulnerable to overzealous IRS field auditors and that we cannot afford to have this matter unresolved for an extended period of time after June 30. We understand that expecting legislation by the end of this month is unrealistic perhaps, but we urge the Committee to move legislation as quickly as possible, through whatever vehicle may be available.

As to the legislation, VDTA subscribes to the Gephardt bill, HR 6311. We believe its four-part test is fair and promises to resolve, once and for all, the question of who is an independent contractor. And, although we are not convinced of the need for informational reporting to the extent provided in the bill, VDTA believes that it can assume this burden if it will serve to clear the air. Reporting will be expensive to our industry and, depending on the threshold level, can be an impossible task when there is constant and rapid movement in and out of the sales force handling a given manufacturer's product. While we anticipate that these requirements will be onerous, we believe that the levels set in HR 6311 and the ability to select alternative requirements is a more realistic approach than others.

In conclusion, VDTA recommends that the Committee report HR 6311 as soon as possible. VDTA alone represents 15,000 dealers who want the matter resolved this year, yet in a realistic fashion. We are proud of our record of participation in America's voluntary tax system, yet will join with the Committee in reaching a conclusion to this long debate.

○